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EXCHANGE RATE MISALIGNMENT

HEARING

BEFORE THE

SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ON

THE CAUSES AND EFFECTS OF THE OVERVALUED DOLLAR IN THE CURRENCY MARKETS AND SOLUTIONS TO CORRECT THE IMBALANCE

OCTOBER 23, 1985

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EXCHANGE RATE MISALIGNMENT

WEDNESDAY, OCTOBER 23, 1985

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, SUBCOMMITTEE ON INTERNATIONAL FINANCE AND MONETARY POLICY,

Washington, DC.

The subcommittee met at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator John Heinz, (chairman of the subcommittee) presiding.

Present: Senators Heinz, Gorton, Mattingly, D'Amato, Proxmire, Dixon, Sasser, Riegle, and Cranston.

OPENING STATEMENT OF SENATOR HEINZ

Senator HEINZ. The Subcommittee on International Finance and Monetary Policy will come to order.

Ladies and gentlemen, today the subcommittee will examine the causes and effects of the overvalued dollar and, more importantly, what can and should be done to correct the imbalance.

To this Senator, it's clear that the system is not working as it should. The dollar has been driven to high levels in the currency markets and has been very resistant to efforts to bring it down. Meanwhile, this tax on our exports and subsidy for foreign imports is creating each year a new record trade imbalance.

The high value of the dollar is also forcing efficient American producers to source their production overseas, either through subcontracting their production to foreign suppliers or transferring their production to overseas subsidiaries. And these are the lucky companies. Many of those less fortunate are merely going out of business.

And yet while our industrial strength is ebbing away, we find that confidence in the dollar continues and the dollar remains at levels far above what most economists agree to be its appropriate level, the level at which balance will be reached in our trade accounts.

Now the textbooks tell us that these astronomical trade deficits should bring down the value of the dollar. But with international capital flows eclipsing trade flows by a factor of 10 to 1, the trade deficit has become, so it seems, just another symptom of imbalance instead of the means of correcting that imbalance.

Without trade flows playing their traditional role of correcting exchange rate overvaluation, what mechanism is there to take their place? Is there a natural mechanism that we can rely on that we could sit back and watch it take over? Can we afford to rely on such a mechanism if that mechanism is the weakening of our econ-

omy, the draining of our industrial strength until all basis for confidence in our economy is gone? I hope not.

Trade balances may come and go but we must recognize that when we lose an industry we're losing something that's exceedingly difficult to recover.

Moreover, the sectors of the economy most vulnerable to dollar overvaluation are those at the cutting edge of technology. These are the industries most dependent upon exports to generate the earnings necessary to fund ongoing research, development, and investment. These are also the industries suffering from the subsidy our high dollar gives to foreign competitors selling in our domestic markets.

Losing their markets abroad and challenged at home, our high-technology sectors, which include our defense industries, are in jeopardy and I again emphasize that this is a condition created not by lack in most instances by quality or efficiency. It is caused by misaligned exchange rates.

To my mind, we can't afford to let this be our adjustment mechanism. Something else has to be found. We can't afford to pay in jobs and technology and security; yet that is what we're doing now.

And we are privileged to have at this hearing today three of our colleagues who have some solutions they believe will address this problem. I am also anxious to learn what the policy of the administration is toward this vital problem, particularly in the light of the recent activities of the Group of 5 [G–5] (United States, Great Britain, Japan, Germany, and France) and the meetings just concluded in Seoul, Korea, of the International Monetary Fund.

The United States has acted as a powerful engine of recovery for the rest of the world these last few years. The question is: What specific policy action can we now expect from Japan, West Germany, and others of our trading partners to restore balance to the trading system? It seems to this Senator that greater coordination of economic policies among the G–5 countries is called for if we are going to resist protectionist pressures, particularly in this country, for these pressures will only be resisted when we have an international trading system that is perceived by all to have benefits for all. This would seem to require a system where imbalances can be addressed and resolved in a timely manner. Perhaps it must be a system where governments take a larger role in promoting orderly adjustment in the market such as is proposed by Senators Moynihan, Baucus, and Bradley, the coordinated intervention in currency markets to cool speculative fervor, in order to nudge markets in a direction already being taken by coordinated macroeconomic policies.

The purpose of our hearing today is to examine the full breadth and scope of those proposals that are before the subcommittee and to try as a result to find out if there is a need for legislation or better policies to be followed by the executive branch.

At this point let me yield to my friend and colleague, the distinguished Senator from Wisconsin, Senator Proxmire.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator PROXMIRE. Thank you very much, Mr. Chairman. I commend you for convening this hearing on the overvalued dollar and what we can do about it. This is a followup to the hearings our committee had in 1984 on the causes and effects of the cumulative appreciation of the dollar against the currencies of other major industrial nations and the adverse impact this has had on the competitive position of American industry and agriculture.

From the fourth quarter of 1980 until late February 1985, the trade-weighted average value of the dollar against the currencies of 10 industrialized nations appreciated by about 80 percent. Now since then there's been some falloff but it is still extraordinarily high. Such an exchange rate change is equivalent to foreign countries building new, high tariff walls against which our exporters must compete. It causes our exports to decline. It also causes our imports to increase as foreign goods become cheaper here. As a result, the U.S. merchandise trade deficit rose from $27 billion in 1981 to $36 billion in 1982, to $60 billion in 1983, to $107 billion in 1984, and it is expected to exceed $150 billion this year. These are calendar years.

Since the collapse of the Bretton Woods system of fixed exchange rates in March 1973, the world community has been operating under a system of floating exchange rates. Its theorists claimed that when a country's exports declined, and its imports grew, the value of its currency would decline and the currencies of its trading partners would appreciate. It was an automatic correcting mechanism theoretically. Thus it was to be, as I say, a self-correcting mechanism that would ensure that each country could remain competitive in international trade.

As we all know, this system has not worked that way. Over the last 4 years the United States has had a massive and growing trade deficit—and still maintains an overvalued dollar. Why? Well, it appears that trade flows are not determining currency values. Rather, the reverse is now true. The value of the dollar determines whether we can sell our products abroad and the value of the dollar is now being determined by capital movements. Presently, capital flows estimated all the way from $30 trillion to $50 trillion—that's trillion—per year dwarf international trade flows estimated at around $2 trillion annually.

The problem is that America's massive budget deficit raises U.S. interest rates above those in other countries. For much of the period since 1980 American short-term interest rates have exceeded those in Germany and Japan by 3 to 6 percentage points. Foreign investors buy dollars to invest here in order to get a higher return on their investment. I want to note, contrary to the administration's assertion, that the vast bulk of these foreign funds are in bank deposits or fixed-rate investments and not in corporate stocks or direct investment. This keeps the dollar overvalued despite our trade deficit. It is destroying the competitive position of our manufacturers and farmers. The longer the high dollar and our consequent trade deficit persist, the greater will be the amount of foreign debt we build up. Ultimately, we will have to pay that off by exporting, and that will result in a lower U.S. living standard than

would otherwise be the case. Our children will pay for America's current profligate behavior.

The amazing thing is that I am not even sure the President, who submits budgets with massive deficits each year, even understands what this is doing to our international trade position. In February of this year, when asked about the overvalued dollar at a news conference, the President said, "It really wasn't a problem. It was a blessing." Well, farmers and laborers who have lost their farms and jobs because of the loss of our overseas markets don't see the John Wayne dollar as a blessing. I think most Americans would prefer a Woody Allen wimp dollar, or maybe a Rodney Dangerfield dollar that wasn't beating their brains out. I'm convinced that the only effective way to achieve that over the long run is with a balanced budget. That means voting for Proxmire amendments that slash appropriations for popular spending programs. It means sharply reducing the $400 billion this country loses in revenue every year in tax expenditures. That is the kind of prescription I think we need to put our country back on its feet.

I am delighted with the quality of the witnesses we have before the subcommittee today and look forward to hearing their views. I am particularly anxious to hear from Senators Moynihan, Baucus, and Bradley, three real stars in the Senate, that show the very high quality of the Democrats in the U.S. Senate, and I know they share our concern about the trade deficit. While I am not convinced that a currency intervention policy can be effective in the long run, unless coupled with the other reforms I mentioned, I do believe it can have some impact on the speculators who sometimes buy dollars simply for short-term profit.

Thank you, Mr. Chairman.

Senator HEINZ. Senator Proxmire, thank you very much.

Senator Mattingly.

Senator MATTINGLY. Thank you, Mr. Chairman.

Mr. Chairman, first I have a statement from Senator D'Amato for the record.

Senator HEINZ. Without objection, it will be inserted in the record.

Senator MATTINGLY. Thank you.

STATEMENT OF SENATOR ALFONSE M. D'AMATO

Senator D'AMATO. I would like to thank the chairman for according us the opportunity to address the reasons and consequences for the high value of the dollar and the effects of the policy of intervention in the exchange market will have upon precipitating a decline in the dollar's value. I am concerned about the overvaluation of the dollar because of its adverse impact upon certain sectors of our economy. Although the strong dollar has had the positive effect of keeping inflation rates low, the dollar's appreciation has caused a decline in the competitiveness of our traded goods sector. Such a decline is partly responsible for our current trade deficit. But what does a trade deficit or current account deficit mean in real terms to the average American? It can have such drastic consequences as a loss of the family farm, a factory closing, and a corresponding increase in unemployment.

Until 1971, the United States and the world adhered to a system of fixed exchange rates as outlined in the Bretton Woods Agreement. After abandoning the gold standard and the fixed rate system, we moved to a floating rate system. The jury is still out on the effectiveness of this system. But intervention in the foreign exchange market under the floating rate system has been tried before; when the dollar dropped too quickly and our economy was forced into a recession. We should avoid that recessionary threat and ensure balanced intervention in the foreign exchange markets. Perhaps a published target to create enforceable limits on the dollar's fall, would be a prudent implementation of our present policy.

Floating exchange rates have allowed our economy to adjust to the capital inflows that are financing our deficit through a concomitant rise in the dollar. That appreciation is the single largest factor underlying our trade deficit. Clearly that deficit and its causes must be addressed. Without a change in the macroeconomic policies underlying the strong dollar, a forced depreciation through sterilized intervention will not work. I would like to complement the Treasury on the G–5 communique which addresses these underlying macroeconomic factors. My only hope is that the other industrial countries are better able to achieve their macroeconomic goals in a more timely way than our promised deficit reduction.

Theoretically, a protracted decline in the dollar, to match its 70-percent appreciation since 1980, will deflate European economies and allow growth in European output and employment. That translates into foreign GNP growth that will facilitate U.S. export growth. I hope that we can explore whether the recent G–5 communique represents a firm commitment to implement this plan rather than a verbal agreement intended to have a psychological effect on the foreign exchange market. In the hearings today, I would like to hear a clarification of this foreign exchange policy. A concrete proposal, like the target zone suggested in Mr. Williamson's testimony, would certainly reinforce the positive strides made with the publication of the G–5 communique.

I appreciate the appearance of today's witnesses and look forward to receiving their testimony.

OPENING STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. Mr. Chairman, I appreciate your holding the hearing today and I think that there can be little doubt that exchange rates do have a significant distorting effect on international trade patterns. I think the current international trade deficit is evidence enough of that.

I don't want to sound as if I believe that exchange rates are to blame for all the world's trade problems. Quite the contrary, I think lack of a coordinated U.S. trade policy, unfair foreign trade practices and barriers, outdated trade laws and agreements, and the recent global economic recession have all contributed to the situation in which we now find ourselves.

By 1971, economic thinkers had become convinced that a shift to floating exchange rates would eliminate exchange rate misalignment, long-term trade imbalances, and the inability to use monetary policy for domestic economic goals. We shifted back then all

right and today, a little more than a decade later, we find ourselves once again questioning our exchange rate system.

The traditional economic models are not working. Interest rates, recession, recovery, inflation, budget deficits are all supposed to act in a predetermined way under today's economic scenario. Instead, we have a situation that bars explanation. We have huge budget and trade deficits; we have lower interest rates; and we have recovered from an economic recession.

At the same time, inflation is way down and foreign investment and imports seem to be drawn to us like bees to honey.

The bottom line is this. Domestic economic policies, exchange rate misalignment, and the trend toward protecting markets have conspired against this country's ability to compete. Our producers are losing their markets. I'd like to know, as does the rest of the American population, what we're going to do about it and when we're going to do it, while still holding on to the beneficial aspects of our current economic situation.

To what extent does the current exchange rate misalignment contribute to our loss of competitiveness and how can the Congress help correct the problem? Those are the questions I hope that our witnesses here today can help answer and to the Senator from Wisconsin I would just say that maybe the dollar or the trade deficit or the trade policy deserves your Golden Fleece Award. I'm not sure which.

Thank you, Mr. Chairman.

Senator HEINZ. Senator Mattingly, thank you.

Senator Gorton.

Senator GORTON. Mr. Chairman, I have no formal opening statement.

It's become fashionable recently to concentrate on single elements or single causes for our trade imbalance, when in fact there are a large number of contributors to that very, very serious problem.

Exchange rates clearly fall into that category. Solutions which seemed perfect in the mid-1940's prove not to be solutions, in more recent time. It's more than appropriate—it's vital—that we have thoughtful discussion of problems relating to exchange rates here. I welcome both the witnesses who are our colleagues and those who come from outside the Senate but who bring us their wisdom, counsel, and advice.

Senator HEINZ. Senator Gorton, thank you.

Senator Dixon.

Senator DIXON. Mr. Chairman, I agree we have three stars in the Senate here. In view of that, I'm going to listen to them and put my statement in the record.

Senator HEINZ. Without objection, so ordered.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I'm pleased to be here this morning as the subcommittee takes testimony on exchange rate issues. We have a distinguished and knowledgeable group of witnesses before us today, and I look forward to receiving their views.

As everyone here knows, the United States is experiencing record trade deficits--deficits that continue to grow. Somewhat less well-known is the fact that the United States has now become a balance-of-payments debtor as well. The United States requires increasing amounts of foreign capital to finance budget deficits and meet other borrowing needs.

There is strong support for the proposition that our trade deficits are caused by a too-strong dollar. While the dollar has come down some recently, it is still significantly overvalued, a fact that makes foreign imports cheaper than they should be and makes U.S. exports uncompetitive in international markets.

The forces responsible for pushing the dollar up are complex. Among the most significant, however, are the huge U.S. budget deficits and the fact that U.S. economic growth rate were for some time significantly higher than the growth rates of our international competitors.

Over the long term, it is clear that exchange rates will reflect economic fundamentals among nations. It seems to me, though, that intervention can also play a useful role, and that intervention is a tool that should be used more often. I was gratified to see, therefore, that the recent communique from the so-called G-5 group of Finance Ministers indicated a willingness and a desire to make appropriate use of intervention.

Recent interventions in the currency markets seem to have helped to bring the dollar down somewhat. This intervention helped to focus the attention of the financial markets on the changes in economic fundamentals that has taken place, but which was not yet reflected in exchange rates.

There has been considerable debate in recent years over when or whether intervention is appropriate. I look forward to hearing the views of this morning's witnesses on intervention and the role it can play, and on other issues related to our exchange rate imbalance.

Senator HEINZ. Senator Moynihan, welcome. We are delighted to have you. Please proceed.

STATEMENT OF DANIEL PATRICK MOYNIHAN, U.S. SENATOR FROM THE STATE OF NEW YORK

Senator MOYNIHAN. Mr. Chairman, with all this pleasant reception, I think on behalf of myself—and I'm here speaking on a measure that has been introduced by myself and Senator Baucus—I will put my statement in the record and respond to your courtesy by being very brief.

Senator HEINZ. Without objection, so ordered.

ADMINISTRATION POLICY OF A CLEAN FLOAT

Senator MOYNIHAN. Like a good many things that we are dealing with today in Congress, we can trace some, at least in my view, back to a rather strong doctrinal position which certain members of the administration took in the early months of the administration. It was on May 4, 1981, that Beryl Sprinkel, the Under Secretary of Treasury for Monetary Affairs, announced his policy of a clean float. It was a pure market orientation one that said the

market knew best what exchange rates should be and no one could know better at the end of the day. In other words, the market gave proof positive, of the correctness of the exchange rate.

The difficulty here is that the market is not only imperfect but is also a different market from the one we have traditionally thought of as setting exchange rates—which is to say, exchange rates determined by trade flows. What Senator Proxmire said is absolutely right: capital movements overwhelm dollar movements associated with the actual movement of goods and services. And capital flows respond to political events and expectations in ways that trade itself does not reflect.

KODAK STORY

The committee might be interested to hear a quick story as to why we need to do something about the dollar's value. I was in Rochester, NY, last spring and noticed in the newspaper a small item reporting that the Kodak Co. was sending a letter to its stockholders for the first time in its 105 years. Kodak is a large company. It's an international company, one of the half-dozen truly international companies based in the United States. You can recognize its products anywhere in the world. Some of those products are elemental and designed to be such—simple film, simple cameras. But their range of activity extends to the most complicated optics and various chemical matters and materials associated with graphics.

And this letter sent to their stockholders was called, "The Dollar and Eastman Kodak." And it said very simply that the overvalued dollar, the increase in the price of the dollar in the last 4 years had cost Kodak $1 billion in profits. I took occasion to call Kodak's head, Mr. Chandler and say, "This is a very unusual thing for you to do." He said: "Well, it is." And I said: "Are the Japanese keeping you out of their markets—is it unfair trade practices by Japan?" The standard solution to all questions of that kind. He said: "No; Kodak has been in Japan for half a century. We go head-to-head against Fuji. We have 15 percent of the market. We expect to get more. We have no problems at all with Japan. But in the Federal Republic of Germany, Kodak film costs 60 percent more than Fuji film. It is simply a function of the arithmetic of the exchange rate and we can't compete."

Then, he said: "Let me tell you, you will always be able to buy Kodak products in the United States. Our plans are not in any sense to leave this market. But if this keeps up just a little bit longer our products won't be made in the United States. We will become a marketing company." And he said: "We won't necessarily build our plants in Japan. We could just build them across the lake in Ontario." In this way, the exchange rate defines the economic conditions of one of the highest performing companies in this country.

DEVELOP A STRATEGIC FOREIGN CURRRENCY RESERVE

And that is what led Senator Baucus and I in July to introduce legislation to require the Secretary of Treasury and the Chairman of the Federal Reserve Board to develop a Strategic Foreign Currency Reserve. Our idea is not complicated. We would require the

Secretary and the Chairman to exchange within 3 years $30 billion in dollars and exchange it for $30 billion in foreign currencies. Our purposes are threefold. First, to resist and moderate any increases in the dollar. Second, to try to bring down the dollar in a steady way to a so-called soft landing. And finally, if you do get suddenly a flight from the dollar and a free-fall in its value, reserve currencies could be used to support the dollar's value. That flight could come very readily these days—as Senator Proxmire mentioned—because the capital that's flowed in in response to interest rates is not in stocks; it is primarily in instruments such as bonds or just bank deposits. And remember, the return—not that I have to tell this committee to remember—but one should remember that the return on a foreign investment of capital in this country is a function of the interest rate and the exchange rate and if that exchange rate starts dropping too fast, money can be pulled out of this country in a matter of seconds.

Finally, Mr. Chairman, enactment of our bill would be a statement by the Congress that it feels the Government should do something about the overvalued dollar. Since we have introduced our legislation, Secretary Baker met with his colleagues, the Group of 5, on September 22 at the Plaza Hotel in New York, and some moderate efforts of this kind have taken place. It seems to us that if Congress would say, "You're doing the right thing and do more of it and here is specific authorization to do quite a bit of it," that would be helpful.

[The complete prepared statement follows:]

STATEMENT BY SENATOR DANIEL PATRICK MOYNIHAN
BEFORE THE SENATE BANKING COMMITTEE'S
SUBCOMMITTEE ON INTERNATIONAL FINANCE & MONETARY POLICY
OCTOBER 23, 1985

Mr. Chairman, thank you for holding this hearing on the single most important cause of our trade problems today: the overvalued dollar. I greatly appreciate the opportunity to appear here to address that problem and to suggest something that we can do about it, unilaterally and immediately: create a Strategic Foreign Currency Reserve.

Summary of Proposal

As you know, in April the Senate Finance Committee held hearings on the overvalued dollar. Following that hearing, I introduced legislation (S.1548) with my distinguished colleague Senator Baucus, to require the Secretary of the Treasury and the Chairman of the Federal Reserve Board to intervene in the foreign exchange markets by purchasing substantial amounts of foreign currencies with dollars thereby creating a "Strategic Foreign Currency Reserve."

They would intervene for the stated purpose of resisting further increases in the dollar's price and encouraging a gradual decline in the dollar's price. They would be required to exchange, within three years, not less than $30 billion in dollars for the currencies of the countries constituting the Group of Ten industrialized countries.

The Secretary and the Chairman would have discretion to purchase foreign currencies at those times when such intervention would be most effective. They also would seek to coordinate such intervention with the central banks of the Group of Ten whenever possible. Finally, they would decide whether to take action to offset all or part of the effect of such intervention on the domestic money supply (that is, the intervention could be "sterilized"). They would balance the relative effectiveness of sterilized versus unsterilized intervention against the potential inflationary effect.

Of course, many fear the consequences of a future "run" on the dollar as much as they are concerned about the dollar's current overvaluation. May I note, therefore, that a Reserve of foreign currencies would also provide the Treasury and Federal Reserve Board with identifiable means to moderate any future sudden large drop in the dollar's price, by selling currencies in the Reserve and purchasing dollars thereby helping to support the dollar.

Intervention Is Only A New Idea To This Administration

Mr. Chairman, intervention in foreign exchange markets is not a new idea: indeed, from the time the dollar began to "float" in 1973 through 1981 the United States intervened often. (Intervention was particularly noteworthy in 1978 - 1980 when the US sought to stem a serious decline in the dollar's price.)

This changed on May 4, 1981, when Beryl W. Sprinkel, thenUndersecretary of the Treasury for Monetary Affairs,

proclaimed the Reagan Administration's policy of a "clean float." For the last four years, while the dollar climbed ever higher, the Administration refused to intervene except in the most extreme cases of "disorderly markets."

Last month, in an abrupt about-face, the Administration appears to have changed its policy. On September 22, the Ministers of the G-5 countries implied that they would pursue coordinated intervention in foreign exchange markets. And so they did in the week following the announcement, and to a lesser extent since.

Legislation To Require Intervention Is Needed

There remains a need for legislation. First, notwithstanding the September 22 announcement, I find myself questioning the commitment of those who, until recently, found a "strong dollar" to be a source of pride. Second, even if the Administration has decided to aggressively intervene in the foreign exchange markets, Congressional direction to do so will firm up our national policy on the matter and will send an even clearer signal to other countries regarding our intentions.

The Overvalued Dollar Is Causing Serious Injury

I do not think that any Member of Congress would, if the proposition were put to him or her, support a 44% tax on American exports and a comparable subsidy of foreign imports.

Yet, since January 1, 1981, the price of the dollar has increased approximately 44% against a basket of currencies of

ten of our major trading partners. The high price of the dollar makes American goods more expensive in foreign markets, while foreign produced goods become cheaper in American markets. In effect, the high price of the dollar acts as a tax on American exports and a subsidy of foreign imports.

The results have been devastating. American businesses are unable to sell their products abroad. At the same time, foreign companies have been able to build distribution networks in the U.S. Perhaps most alarming, U.S. companies are being forced to import finished products and major components just to remain competitive here at home.

The increase in the price of the dollar during the last four years has occured despite record merchandise trade and current account deficits -- a cumulative $283 billion and $149 billion respectively. Under the floating exchange system prevailing since 1973, such deficits should depreciate the dollar, since foreign exchange must be brought with dollars to pay for the imports, and the increased supply of dollars should reduce the price of the dollar as against foreign currencies.

This has not happened. Instead, the price of the dollar has risen sharply. Why?

Why The Dollar Has Risen So High

The price of the dollar has risen because there has been of extraordinary foreign demand for dollars to invest in this country. Foreign investors have bought dollars with their own currencies in order to invest in the U.S., attracted by higher

real interest rates (resulting from the Administration's unprecedented budget deficits -- a cumulative $600 billion since 1981), as well as by expectations of greater economic growth and lower inflation here than abroad.

The price of the dollar is now largely determined by international investment, not trade, flows. Foreign exchange transactions for investment purposes are estimated to be at least ten times the amount needed to finance international trade transactions. Rapid and large scale capital flows are possible as a result of liberalized and computerized international financial markets.

But international foreign exchange markets, like any market, are subject to numerous market imperfections. Decisions may be based on dated, erroneous, incomplete or non-economic information. Decisions may also be made in anticipation of the continuation of market trends -- a phenomenon often referred to as "bandwagon effects."

The combination of large international capital flows and market imperfections have led to great short term fluctuations ("volatility") and have contributed significantly to the market overshooting a dollar price that would reflect underlying trade realities ("misalignment").

Legitimate Fears Of A Future Crash In The Price Of The Dollar

At the same time, there are many who believe -- and fear -- that the combination of continuing merchandise trade and current

account deficits, reduced expectations of economic growth in the US, and market imperfections could produce a sharp drop in demand for dollars to invest in the US. Such a "run" on the dollar would lead to a sudden and sharp drop in the dollar's price -- and a corresponding sudden rise in the cost of imported goods that could, in turn, re-ignite inflation, causing a painful adjustment process and seriously damaging the economy.

Lest anyone doubt how easily such a run could develop, and not necessarily in response to changes in underlying market fundamentals, recall that the dollar dropped 2.4% in 24 hours between 2:30 pm on March 18 and 2:30 pm on March 19, when an Ohio thrift institution went bankrupt and fears spread that there would be a run on other Ohio savings and loans institutions.

Mr. Chairman, the costs to the US economy associated with the dollar's excessive increase in price, and possible sudden sharp drop in price in the future, are significant and should be avoided. A gradual decline in the price of the dollar from its current high levels is desirable and should be encouraged.

What Should Be Done?

What, then, can be done to achieve a gradual and lasting reduction in the dollar's price to a level that better reflects underlying trade factors as relative productivity and inflation?

First, we must take action to reduce the Federal budget deficit, in order to reduce the high interest rates that attract foreign capital. Second, the governments of foreign

countries with underpriced currencies must stimulate economic growth, to enhance the desirability of investing in those countries. And finally, the governments of all industrialized nations representing the major trading currencies must coordinate their macroeconomic policies.

Yet these actions are unlikely to occur, at least to a sufficient extent, in the near future.

There is, however, something the United States can do to supplement and complement these actions.

Intervention by the United States to purchase substantial amounts of foreign currencies with dollars, thereby developing a "Strategic Foreign Currency Reserve," could correct market imperfections, reduce the extent and slow the pace of exchange rate movements, resist further increases in the dollar's price, and assist its gradual decline.

As I noted earlier, Mr. Chairman, a Strategic Foreign Currency Reserve also would provide the Treasury and Federal Reserve Board with the means to moderate any sudden large drop in the dollar's price, by selling the foreign currencies in the Reserve and purchasing dollars thereby helping to support the dollar's price.

Congress Should Act Now to Require Intervention

We cannot afford to wait any longer. The overpriced dollar represents a real and present danger of "de-industrialization." The Administration's recent agreement with other G-5 countries to intervene on a coordinated basis is a step in the right direction -- but Congress should help firm the Administration's resolve to move forward.

Senator HEINZ. Senator Moynihan, thank you.
Senator Baucus.

STATEMENT OF MAX BAUCUS, U.S. SENATOR FROM THE STATE OF MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Chairman, it's a pleasure to join my colleagues—and yours—from the Finance Committee in discussing the problem of the dollar.

I see by the witness list that the administration has sent a witness to this hearing. You may recall that in April, when the Senate Finance Committee held hearings on the dollar, the administration declined to testify. Back then the administration didn't think we had a problem.

VIEWS OF THE DOLLAR

Indeed, until very recently the administration denied there was such a thing as an overvalued dollar. To the President it looked like a strong dollar—and everyone likes strength.

To jet setters the expensive dollar looked good as well. It lowered the cost of a trip abroad. A high dollar makes imported luxuries less expensive. It's great for the American tourist abroad.

But for others the overvalued dollar is a source of real pain. If you compete with imports or if you try to export, the appreciation of the dollar has been like a lead weight. Today the dollar is more than 40 percent above its 1980 level—that's 40-percent tax on exports and a 40-percent subsidy for imports. In a highly competitive world our workers, businessmen, and farmers don't need the Government making their job tougher. But that's what the dollar's appreciation has done.

A FEW EXAMPLES

I'd like to talk about just a few cases.

Paper

The first comes from David Taylor, vice president at Boston's State Street Bank and Trust and a man who has spent a decade analyzing basic industry winners. But in the paper industry he has found an anomoly.

The U.S. paper industry has abundant forests, and relatively inexpensive power. It has made a major investment in efficient new paper machines. The United States is without question the most efficient paper producer in terms of factors of production. But the rise in the dollar has made it the high-cost producer.

The appreciation of the dollar means that a Finnish producer can buy wood chips in the United States, pulp them in less efficient Finnish mills, and then export the pulp to the United States—and undersell United States producers by 20 percent.

Kodak

The second example I'd cite is a more familiar one: Kodak. Chief executive officer Colby Chandler told the Senate Finance Commitee in April that in the last 4 years the surge in the dollar had reduced

Kodak's earnings by more than $500 million—and that was without factoring in lost sales or reduced margins. He estimated the total currency effect at double or triple.

I think I will never forget hearing Mr. Chandler say that at Kodak they increased productivity by 13 percent in 1984—and that it was not enough to offset the appreciation of the dollar.

Farmers

And, finally, Mr. Chairman I want to remind everyone about the plight of the American farmer. For him the dollar is a double whammy. Wheat is priced in dollars. An increase in the value of the dollar means U.S. wheat costs more to other countries. It also means other producers make more without raising their prices. The Argentine seller gets more pesos for every bushel of wheat without doing anything. This encourages him to produce more and to cut his price in dollars—and so to drive us out of still more foreign markets.

WHY WE NEED TO ACT

The surge in the dollar has cost us dearly. It has reduced the competitiveness of our exports. Market share lost will be difficult to regain. It has led efficient producers like Kodak and Caterpillar tractor to shift production abroad. The jobs lost may never be regained. It has eroded the value of existing foreign investments.

Less often recognized, Mr. Chairman, but just as true, is that the high dollar has imposed costs on other nations as well.

Savings which might have been used to finance investment and long-term growth in these countries have flowed into the United States instead. This means no resumption of growth or demand in foreign markets.

The debt-service burden for the LDC's has grown with both higher interest rates and a higher dollar. This burden endangers their political stability. It also reduces their ability to purchase goods from us. Latin America used to be one of our largest markets—but slow growth and a heavy debt burden have cost us that market.

WHERE ARE WE NOW

What worries me, Mr. Chairman, is where we go from here.

I have no doubt that the appreciation of the dollar has caused real and serious harm. I have no doubt that we must bring the dollar back down to Earth.

But some of the harm is permanent. Customers who have turned to other suppliers may not return immediately to American companies. It will be a long hard fight to regain market share. Jobs lost as plants move abroad are unlikely to be regained.

I believe that most companies wait as long as they can before they move plants abroad and change suppliers. If this administration and the Congress had acted sooner to bring down the dollar—or to slow its boom—we would have lessened the damage. In that sense we have already waited too long.

But we should not wait any longer. Bringing the dollar back to Earth will not solve all our trade problems—but failure to act in this area will make anything else we do more difficult.

LEGISLATION

On July 31, Senator Moynihan and I introduced legislation calling for creation of a strategic foreign currency reserve of $30 billion. The next day Senator Bradley followed with a similar bill.

All three of us acted out of a conviction that we had to push the administration to act.

On September 22, Secretary Baker and Federal Reserve Chairman Volcker joined the Finance Ministers and Central Bankers of France, Germany, Japan, and the United Kingdom in a statement that the dollar's value was inappropriate. The G–5 communique is carefully worded, but it says that the dollar is too high. It seems to promise intervention—and indeed, the dollar fell after the announcement.

Why, then, do my colleagues and I think legislation creating a strategic foreign currency reserve is necessary? Didn't the G–5 announcement moot our legislation?

Read beneath the headlines. In the period immediately following the announcement the dollar fell. It fell on the expectation of intervention, on some small intervention by the United States, and on greater intervention by the Japanese. But as time has continued, the dollar has come back up some. It seems that only the Japanese are intervening in a big way.

Mr. Chairman, there is a limit to Japanese intervention against the dollar. In the end, the only country that can intervene sufficiently to drive the dollar back to reasonable levels is the United States. We should not go it alone, but we should not sit out the exercise.

Our legislation directs the United States to participate. It makes clear the commitment of the U.S. Government to a rational decline in the value of the dollar.

I expect that enactment of such legislation would have an effect beyond the size of the intervention. A statement by the Congress—a statement backed up by legislation—that the dollar is overvalued would be a strong signal to the rest of the world. And we all know that in the currency markets signals are sometimes as important as reality.

BEYOND LEGISLATION

At the same time, Mr. Chairman, we must push for action on the vague promises of the G–5 communique.

We in the United States must act to reduce our budget deficit. And for that we need leadership by the President and bipartisan cooperation in the Congress.

Japan must also move to stimulate domestic demand and restrict capital flows out of Japan. Japan has a huge excess of savings. The limited domestic demand—and limited domestic investment drive that excess capital abroad. It helps drive up the value of the dollar—and it worsens the trade deficit. Stronger domestic demand and investment in things like housing, roads, and infrastructure

would do a great deal to alleviate the imbalance between our countries.

CONCLUSION

Mr. Chairman, I do not believe that the Strategic Foreign Currency Reserve Act of 1985 is the answer to all the economic or trade problems of this Nation.

We will have to act to spur productivity growth and restore some basic competitiveness. But I do believe that we cannot stop the downward spiral unless we turn the dollar around. We must stop having our currency work against us. I urge the administration to join other nations in looking at the very structure of the international monetary system. A world in which capital flows dominate trade flows and so dictate the value of a currency is not the world we thought we were creating with the change to floating exchange rates in 1973.

But while we await decisions on a new international monetary system let's at least tell the rest of the world that we believe there is something wrong. I may not feel competent to say what the correct value of the dollar is, but I feel capable of saying that what we face today is incorrect. Let's make that conclusion clear to the world.

Senator HEINZ. Thank you very much, Senator Baucus.

Senator Bradley.

STATEMENT OF BILL BRADLEY, U.S. SENATOR FROM THE STATE OF NEW JERSEY

Senator BRADLEY. Thank you very much, Mr. Chairman. I would ask unanimous consent that my entire statement could be placed in the record.

Senator HEINZ. Without objection, so ordered.

Senator BRADLEY. I will just read selectively from the statement.

Mr. Chairman, I think that the key here to understanding the cause of the trade crisis is a combination of world events and U.S. policy that has created an unprecedented rate of net capital inflow amounting to $100 billion per year. These capital flows have inflated the dollar to an uncompetitive exchange rate that functions like a 40-percent to 60-percent tax on all American products that compete internationally.

FACTORS RESPONSIBLE FOR CAPITAL INFLOWS

I think there are four factors responsible for the explosion of net U.S. capital inflows from a rate of about $10 billion in 1982 to a rate of $100 billion last year.

First, the 1982 low world oil prices and rising United States interest rates forced Mexico to the brink of default on its international debt. The ensuing Latin American debt crisis brought new lending by United States commercial banks to a halt. It also accelerated flight of private capital from countries like Venezuela and Argentina.

Between 1982–84, for example, U.S. gross capital inflows remained steady at about $90 billion per year; while gross capital

outflows shrank from $120 to $20 billion per year. In other words, the banks just stopped lending.

The second cause is that as a result of the 1981 tax cuts the U.S. Federal budget deficit jumped from $64 to $148 billion in 1982—an increase of 131 percent. The Treasury was forced to borrow to make up the difference, putting unprecedented strain on U.S. capital markets and further upward pressure on U.S. interest rates. The debt crisis and new U.S. Government borrowing combined to divert world capital from Latin America to this country.

The third cause is that in November 1983, the Japanese Government liberalized their financial markets. The liberalization consisted principally of measures designed to facilitate capital flows from Japan to the United States. The measures included lifting restrictions on foreigners' ability to issue Samurai bonds, and four or five other things, the net result of which was that it was easier for Japanese savers to invest in United States Government securities.

The fourth factor for this increase in capital flows is that the administration repeatedly asserted and demonstrated an unwillingness to intervene in international currency markets, thereby prompting speculators to acquire dollar denominated assets. I guess they reasoned that absent Government intervention speculative pressure and the fundamentals that I've just listed would push the dollar up, guaranteeing high returns on dollar investments solely because of exchange rate movements.

So the debt crisis, the United States budget deficit, the one-way liberalization of Japanese capital markets, and the speculation predicated on our unwillingness to intervene combined to create unprecedented rates of net United States capital inflows.

This inflow of capital, while welcome to certain investment sectors, simultaneously inflated the dollar on world markets to create a completely uncompetitive U.S. exchange rate.

Has the capital inflow helped U.S. industry retool? The statistics there are clear: No; they haven't. Average annual rate of capital expenditure on plant and equipment between 1981 and 1983 was about 10 percent lower than the average on that expenditure between 1978 and 1981. In other words, from 1981–83, about $275 billion was invested while between 1978 and 1980 there was about $305 billion.

Senator HEINZ. Are those current or constant dollars?

Senator BRADLEY. Constant 1984 dollars.

So to resolve our trade crisis, we have to reverse the four trends that I have just described that caused the net capital inflows.

Now some of the things we have to do are going to take a long time—Latin America debt rescheduling, getting LDC economies to follow a more market-oriented approach. And even with the passage of Gramm-Rudman it's going to take 5 years to balance the budget. And getting the Japanese investment climate to change or getting the Japanese to assume a greater role in reorienting their foreign capital investment from the United States toward Third World countries is also going to take a long time.

Because of this, last May I offered a resolution on the floor as an amendment to a Foreign Relations bill that urged the administration to intervene. That passed with bipartisan support, followed in the summer by the two bills that are before the committee, the bill

by Senator Moynihan and Senator Baucus and the bill that I offered in August that dealt primarily with this same issue, which is, how do we get the value of the dollar down?

SUMMARY OF THE STRATEGIC CAPITAL RESERVE ACT

And as Senators Baucus and Moynihan have said, there's a response from the administration on this issue that they would intervene. Let me briefly summarize what the Strategic Capital Reserve Act does.

It has three provisions. First, it directs the Federal Reserve and the Treasury to purchase at least $3 billion in foreign securities during any fiscal quarter when two conditions are met. The first condition is that the previous four quarters' current account deficit have to have run at a yearly rate of 1.5 percent of GNP, or $50 billion in 1984.

Second, the dollar has got to be at least 15 percent higher than the level required to balance the current account.

The second provision of the bill—and I think this is an important one—says that the Federal Reserve should not raise cash for these purposes in domestic bond markets. Otherwise, the purchase would simply raise interest rates. In other words, it calls for unsterilized intervention.

Third, the act directs the President to negotiate to establish an international commission of representatives of G–10 countries to investigate ways of stabilizing the financial system and calls for quarterly international consultations to coordinate strategic capital reserve operations with other major central banks.

In addition, it caps the allowable interventions at the quarterly level to the current account deficit.

Now, Mr. Chairman, I think the main strength of the proposal that I have just outlined is that it lays out a clear, credible plan to improve the competitiveness of the dollar. It sets out clearly the minimum level of currency intervention that markets should expect when capital flows threaten to distort trade patterns and it improves greatly the credibility of the administration's recent G–5 announcements concerning the desirability of realigning the dollar by calling for unsterilized intervention.

I would like to underline this. Only unsterilized intervention is likely to have a long-term impact on the value of the dollar. Sterilized intervention can have an impact on the value of the dollar only if it simultaneously raises interest rates. In other words, sterilized intervention can improve the competitiveness of the dollar only if it has a recessionary impact on capital markets.

Now the intervention last winter, what I call the Margaret Thatcher intervention, is probably an example of sterilization. It had no lasting impact because the markets did not believe the U.S. Government supported it. This bill is much more likely to have an effect on the exchange rate of the dollar because its enactment would indicate a seriousness of purpose that has been lacking up to now.

If the strategic capital reserve had been enacted last year, each fiscal quarter would have met the conditions for a $3 billion minimum intervention.

So, Mr. Chairman, I would submit the balance of my statement to the record and simply state that I don't think that we can talk about the trade crisis and not address 60–70 percent of the cause of the trade deficit, and I think that we are being needlessly timid if we assert that the Congress has no responsibility or role in assuring that we have an orderly decline in the value of the dollar. I think that the strategic capital reserve would asset such a role. I also happen to think that the bill offered by Senator Moynihan and Senator Baucus is saying the same thing. It's your committee that's going to have to act and we hope that you won't be timid.

[The complete prepared statement follows:]

Bill Bradley
U.S. SENATOR
Democrat/New Jersey

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BRADLEY TESTIFIES ON STRATEGIC CAPITAL RESERVE BILL
TO MAKE THE DOLLAR MORE COMPETITIVE

For Immediate Release: Wednesday, October 23, 1985
Contact: Lisbeth Pettengill, John Steele

In a statement that criticized the Administration's economic and trade policies, Senator Bill Bradley (D-N.J.) today testified before the Senate Banking Committee in support of his Strategic Capital Reserve legislation. He called on the Committee to endorse his proposal to make the dollar more competitive in foreign markets.

Following are excerpts from the Senator's testimony.

"The Administration's economic policy devastates American manufacturing, mining, and agriculture in favor of trade-insulated sectors such as construction and certain investment sectors such as real estate.

"The cause of the trade crisis has been a combination of world events and U.S. policy that has created unprecedented rates of net capital inflow amounting to $100 billion per year. These capital flows have inflated the dollar to an uncompetitive exchange rate.

"To resolve our trade crisis, we must combat the four trends creating net capital inflows. But most of the policy tools available to accomplish this would either take a long time to have an effect or have a relatively minor impact. What we need is a transition strategy to put American industry back on its feet until longer-term measures can take effect.

"In May of this year, a resolution I offered urging the Secretary of the Treasury and the Federal Reserve Board to

consult with the G-5 Finance Ministers to bring down the value of the dollar, carried on the floor of the Senate with bi-partisan support. The House agreed to the resolution in conference, and it became Section 810 of the Foreign Relations Authorization Act of 1986. Just before the August recess, I introduced the Strategic Capital Reserve Act, laying out a plan for orderly, unsterilized intervention to improve the competitiveness of the dollar and to stabilize international currency markets. Two months later, the Administration announced an agreement between the G-5 Finance Ministers to bring down the value of the dollar. The dollar immediately dropped 6% against most foreign currencies, and over the next two weeks several central banks intervened with between $3 billion and $4 billion to keep the dollar at the lower rate.

"The Strategic Capital Reserve Act (S. 1571) directs the Federal Reserve and the Treasury to purchase foreign currencies whenever net capital inflows seriously threaten to disrupt trade patterns.

"The main strength of the proposal is that it lays out a clear, credible plan to improve the competitiveness of the dollar. The bill sets out clearly the minimum level of currency intervention that markets should expect when capital flows threaten to distort trade patterns.

"In addition the act establishes a strategic reserve of foreign currencies that would provide us with a tool to cushion any sharp of disruptive fall in the value of the dollar."

The complete text of the Senator's testimony is attached.

end

STRATEGIC CAPITAL RESERVE TESTIMONY
Senator Bill Bradley
October 23, 1985

In hearings before the Finance Committee on textile and apparel trade, Senator Thurmond drew a parallel between trade policy and defense policy. His premise was that it is possible, through trade policy, to advance the interests of all Americans; just as it is possible to advance the interests of all Americans through prudent defense policy. I would argue that our trade policy too frequently has been more like tax policy than defense policy. Trade policy, as Congress and the Administration have traditionally pursued it, has not always advanced the interests of all Americans. More often, it has created loser industries every time it created a winner industry. Just like our crazy quilt of tax laws, the sector-specific legislation that has constituted most of our trade policy diverts resources to certain selected industries--often very deserving ones--at the expense of other industries that are equally deserving. This is just as true of the supposedly hands-off approach that this Administration has pursued as it is of Congressional trade initiatives. The Administration's present economic policy devastates American manufacturing, mining, and agriculture in favor of trade-insulated sectors such as construction and certain investment sectors such as commercial real estate.

The cause of our trade crisis has been a combination of world events and U.S. policy that has created unprecedented rates of net capital inflow amounting to $100 billion per year. These capital flows have inflated the dollar to an uncompetitve exchange rate that functions like a 40% to 60% tax on all American products that compete internationally.

Four inter-related factors are responsible for the explosion of net U.S. capital inflows from a rate of $10 billion in 1982 to a rate $100 billion last year. First, in 1982, a combination of low world oil and resource commodity prices together with rising U.S. interest rates forced Mexico to threaten default on its international debt. The ensuing Latin American debt crisis brought new lending by U.S. commercial banks to a halt, and accelerated the flight of private capital from countries like Venezuela and Argentina. Between 1982 and 1984, for example, U.S. gross capital inflows remained steady at about $90 billion per year, while gross capital outflows shrank from $120 billion to $20 billion per year. Second, as a result of the 1981 tax cuts, the U.S. federal budget deficit (measured by national product

accounts) jumped from $64 billion to $148 billion in 1982--an increase of 131%. The Treasury was forced to borrow to make up the difference, putting unprecedented strain on U.S. capital markets and further upward pressure on U.S. interest rates. The debt crisis and new U.S. government borrowing combined to divert world capital from Latin America to this country.

Third, in November of the following year, the Reagan Administration urged Nakasone to liberalize Japanese financial markets. The liberalization consisted principally of measures designed to facilitate capital flows from Japan to the U.S.: lifting restrictions on foreigners' ability to issue Samurai bonds, relaxation of Japanese "administrative guidance" that restricted overseas lending by Japanese banks, relaxation of Japanese restrictions on trading of foreign commercial paper, and relaxation of restrictions on overseas bank accounts held by Japanese residents. The reason for emphasizing liberalization of Japanese capital outflows to the U.S. no doubt reflected concern about the relatively high cost of capital to American businesses compared with Japanese businesses. But the resulting upward pressure on the dollar has harmed American businesses more than Japanese capital has helped them.

Fourth, the Administration repeatedly asserted and demonstrated its unwillingness to intervene in international currency markets, prompting speculators to acquire dollar-denominated assets. They reasoned that, absent government intervention, speculative pressure and the fundamentals I have just listed would push the dollar up, guaranteeing high returns on dollar investments solely because of exchange rate movements. The debt crisis, the U.S. budget deficit, the one-way liberalization of Japanese capital markets, and speculation predicated on our unwillingness to intervene, combined to create unprecedented rates of net U.S. capital inflow. This inflow of capital, while welcome in investment sectors, has simultaneously inflated the dollar on world markets to completely uncompetitive exchange rates. These exchange rates have caused a hidden recession among trade-sensitive American industries.

Has the inflow of foreign capital helped American industry retool? According to the Economic Report of the President, the average annual rate of capital expenditure on plant and equipment in the U.S. between 1981 and 1983 was 10% lower than the average rate of expenditure between 1978 and 1980. The average rate was $275 billion between 1981 and 1983 in constant 1984 dollars, while the average rate was

$305 billion between 1978 and 1980 in constant 1984 dollars. Since the new capital has not been financing a private sector investment surge, there has been no positive effect of net capital inflows on business investment to off-set the damaging impact on the dollar.

To resolve our trade crisis, we must reverse the four trends creating net capital inflows that I have described. But most of the policy tools available to accomplish this would either take a long time to have an effect or have a relatively minor impact. Measures to relieve the debt burden in Latin America ultimately depend on new confidence in Latin American economies on the part of commercial bankers. But this requires fundamental changes in debtor nations' economic structure. Such changes demand generous windows of time to avoid hardship in the debtor countries. The Senate has just enacted draconian legislation to reduce the federal budget deficit, but even this will require five years. And the Senate demonstrated the day after passage of Gramm-Rudman that it did not have the will to cut the budget deficit in accordance with the prescriptions of the bill. We could and should enact legislation to ensure that American investors enjoy investment opportunities and tax treatment in Japan comparable to the opportunities and tax treatment enjoyed by Japanese investors in the U.S. And we should encourage Japan to divert its capital outflows to capital-poor countries such as Mexico, Peru, and Brazil. But these measures would have a relatively small impact on the overall capital flow imbalances plaguing the world trading system today. What we need is a transition strategy to put American industry back on its feet until longer-term measures can take effect.

In May of this year, a resolution I offered urging the Secretary of the Treasury and the Federal Reserve Board to consult with the G-5 Finance Ministers to bring down the value of the dollar, won the strong, bi-partisan support of the Senate. The House agreed to the resolution in conference, and it became Section 810 of the Foreign Relations Authorization Act of 1986. Just before the August recess, I introduced the Strategic Capital Reserve Act, laying out a plan for orderly, unsterilized intervention to improve the competitiveness of the dollar and to stabilize international currency markets. Two months later, the Administration announced an agreement between the G-5 Finance Ministers to bring down the value of the dollar. The dollar immediately dropped 6% against most foreign currencies, and over the next two weeks several central banks intervened with between $3 billion and $4 billion to keep the dollar at the lower rate.

On October 8, the Journal of Commerce reported that Japanese Finance Minister Takeshita pledged to Secretary Baker that Japan would continue to follow up the G-5 meeting and would work to keep the dollar's value low in relation to the yen. Contributions by Japan, however, will not convince Wall Street traders that the major player--the U.S. government--is serious about overseeing the value of the dollar. Until the Administration lays out a plan for monetary and exchange policy designed to stabilize international currency markets, Wall Street traders will regard calls for intervention as side-shows staged for the benefit of Congress. And as long as traders suspect that the Administration is not serious about intervention, the private capital markets will have no reason to stop moving speculatively into dollar-denominated assets. Now more than ever, we need to lay out policy reflecting the concern of this government about the effect of the value of the dollar on U.S. industrial competitveness.

The Strategic Capital Reserve Act (S.1571) directs the Federal Reserve and the Treasury to purchase foreign currencies whenever net capital inflows seriously threaten to disrupt trade patterns. The act has three provisions. First, it directs the Federal Reserve and the Treasury to purchase at least $3 billion in foreign securities during any fiscal quarter when two conditions are met. The first condition is that each of the previous four quarters' current account deficit must have run at a yearly rate exceeding 1.5% of GNP, or about $50 billion in 1984. The second condition is that the dollar must be 15% higher than the level required to balance the current account. Whenever these two conditions are met, we have a serious trade problem on our hands. The second provision directs the Federal Reserve not to raise cash for these purchases in the domestic bond market. Otherwise, the purchases would raise interest rates. Because of the impact on interst rates, raising cash in domestic bond markets to finance purchases in foreign currency markets is called sterilizing the intervention. So the second provision calls for unsterilized intervention. Third, the act directs the President to negotiate to establish an international commission of representatives from the G-10 countries to investigate ways of stabilizing the world financial system. The act also calls for quarterly international consultations to coordinate Strategic Capital Reserve operations with other major central banks, and caps allowable interventions at the quarterly level of the current account deficit. Representative Lundine introduced an identical bill as H.R. 3498 on October 3 in the House.

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such private sector initiatives. But the Strategic Capital Reserve does begin to move us toward a resolution of the other problems I have sketched. As to the debt crisis, for example, the Federal Reserve and the Treasury could make limited Strategic Capital Reserve purchases of Latin American securities to alleviate the severe debt burden under which some Latin American countries are suffering. These purchases would function like small, long-term official loans to capital-poor countries. To encourage serious action on reducing the federal budget deficit, Congress could release the Administration from Strategic Capital Reserve intervention requirements in any fiscal quarter that the budget deficit ran at an annualized rate less than 3% of GNP. To ensure international coordination of exchange rate policies, Congress could release the Administration from intervention requirements in any quarter that other central banks had intervened in accordance with certain agreements. And if support for a new international monetary conference continues to grow, Congress could release the Administration from Strategic Capital Reserve requirements once the Administration had initiated a conference to consider a specific agenda of international monetary reforms. I mention these possibilities to illustrate the flexibility of the framework that the Strategic Capital Reserve provides.

The Strategic Capital Reserve Act recommends an active role for Congress in setting trade and macroeconomic policy. But it seeks an alternative to special interest activism that has eroded Congressional effectiveness and fostered cynicism about Congress' ability to provide economic leadership. The Administration's macroeconomic policy, although hardly activist, is not free from the charge of promoting special interests, either. Under present conditions, it appears more and more like an industrial policy favoring certain investment and trade-insulated sectors. It does so at the expense of an exchange rate tax on sectors like manufacturing, mining, and agriculture, that compete internationally. The Strategic Capital Reserve, very simply, seeks to reverse this. We should reward ourselves as consumers, and challenge ourselves as producers; instead we are indebting ourselves as consumers, and punishing ourselves as producers.

The main strength of the proposal is that it lays out a clear, credible plan to improve the competitiveness of the dollar. The bill sets out clearly the minimum level of currency intervention that markets should expect when capital flows threaten to distort trade patterns. And it improves greatly the credibility of Administration announcements concerning the desirability of realigning the dollar by calling for unsterilized intervention. Only unsterilized intervention is likely to have a long-term impact on the value of the dollar. Sterilized intervention can have an impact on the value of the dollar only if it simultaneously raises real interest rates. In other words, sterilized intervention can improve the competitiveness of the dollar only if it has a recessionary impact on capital markets. The intervention last winter is probably an example of sterilization: it had no lasting impact because the markets did not believe the U.S. government supported it. This bill is much more likely to have an effect on the exchange rate of the dollar because its enactment would indicate a seriousness of purpose that has been lacking up to now.

In addition, the act establishes a strategic reserve of foreign currencies that would provide us with a tool to cushion any sharp or disruptive fall in the value of the dollar. We cannot wait for a financial crisis to prove the necessity of such a reserve any more than we can hope the trade deficit will disappear while capital inflows swamp the currency markets.

If the Strategic Capital Reserve had been enacted last year, each fiscal quarter would have met the conditions for a $3 billion minimum intervention. Thus, the bill would have required the purchase of $12 billion worth of <u>foreign securities</u> with new money. The Federal Reserve actually expanded the monetary base last year by purchasing $12.5 billion worth of <u>U.S. government securities</u> with new money. Under the Strategic Capital Reserve Act, the Federal Reserve would have been free to decide whether economic considerations apart from the exchange rate required additional money supply expansion or not. In any case, this act does not reduce the freedom of the Federal Reserve to pursue independent money supply targets. Moreover, there have been very few years when all four quarters would have triggered its provisions.

The Strategic Capital Reserve does not address the problem of unfair foreign trade practices. We must, at a minimum, harness private sector initiatives to respond adequately to unfair foreign trade barriers. I have introduced the Trade Partnership Act (S.1669) to promote just

Senator HEINZ. Senator Bradley, thank you very much.

Let me say to all three of you that you have done between you as fine a job of, on the one hand, outlining the consequences to U.S. industry, jobs, our economy, as I have ever heard presented before any group, including committees of Congress, and as particularly well done by Senators Moynihan and Baucus and you, Senator Bradley, have done as fine a job, of analyzing the causes of how we got to where we are as anyone I have heard testify or lecture on the subject.

ISSUE OF STERILIZATION

And you're quite right, that the two bills—the Moynihan-Baucus bill and the Bradley bill—have much in common. There is one principal difference between them, which is the issue of sterilization, which for those of you who think we are talking about some biological phenomenon of high-technology biological phenomenon, we are talking about whether domestic monetary policy should or should not be used to offset the actions the Treasury Department might take in the purchase of foreign currencies.

What Senator Bradley's position is, as I understand it, if I understand sterilization, is that he would not permit the Federal Reserve to take actions to offset domestic monetary consequences. The kind of actions that the Fed might take would be in effect to purchase dollars by selling T-bills. Senator Moynihan would permit that.

Senator MOYNIHAN. May I say, Mr. Chairman——

Senator HEINZ. Is this a real or imaginary dispute that you have?

Senator MOYNIHAN. Well, Senator Baucus and I think—I don't speak for my colleague because he can speak for himself—but I think this is an issue we would like to submit to the Banking Committee because our bill gives the Treasury and the Federal Reserve the discretion to sterlize intervention and we think there is an argument that if you don't do so you have an inflationary effect.

There's one other difference between the Bradley legislation and ours I'd like to draw attention to and, again, I think the committee should decide. We are not so sure we could determine a correct price for the dollar. I think that Senator Bradley is more optimistic in that regard than we are. It's theoretically possible, but we look at practitioners' estimates of the dollar's overvaluation and they range from 15 to 40 percent. It's hard in our view to know precisely how much the dollar is overvalued—but we think it's too high and lower is better and that's about where we are.

Senator HEINZ. Let me ask you—and this really gets to the heart of what I suspect even you may have some questions about, which is the automaticity of both your bills, which automaticity is different. You have a specific amount of money, Senator Moynihan, that you would commit to purchases over a 3-year period. Senator Bradley's automaticity is more phased but it seems to me runs into some difficulty on the question of lag times involved.

My question is a broader one. Is there such a thing as too much intervention? Is there such a thing as too low a dollar? Is the Rodney Dangerfield dollar, one that does not get any respect—I think is the operative definition of that—is this the dollar we

want? Really, isn't what we want a "nerd" dollar, one that is neither fish nor fowl, neither strong nor weak?

Senator MOYNIHAN. Let the Chair note that Senator Baucus will answer the "nerd" question.

Senator BAUCUS. I think we want an Aristotlian dollar, a golden mean dollar. Obviously we can go too far in any direction here.

Senator HEINZ. That's a "nerd" dollar.

Senator BAUCUS. Well, I would use a different term.

As to your first question on sterlized or unsterlized intervention: We should leave that question to the discretion of the Secretary of the Treasury and the Chairman of the Federal Reserve. It will vary with circumstances.

The other side of the coin is that unsterilized intervention can be inflationary. So you have to leave that decision to the Treasury Secretary and the Federal Reserve Chairman depending on the economic situation.

Senator HEINZ. I'm tempted to ask Senator Bradley, who I know has strong feelings about it, and I will at a later time, about the question of sterilization, but I want to get to a broader question and pursue what I was asking you.

There is a school of thought that says intervention is not bad; it can be very good, but it doesn't work when you're going against the fundamentals. Therefore, intervention works best when you're leaning with the wind. Now when you're leaning with the wind, you might say everything works rather well but you might get carried away a little further than you had intended.

Both of your bills do have automatic devices in them and the most obvious one is the fact that you have a set amount of currency that you want to purchase over a 3-year period.

What is the danger of overshooting the mark?

Senator MOYNIHAN. Over a 3-year period? No danger that I can see. I think Senator Baucus would agree. I mean, we are so far out of line. I'll tell you, Mr. Chairman, I think our thinking here was that we are dealing with a Treasury Department that was doctrinally opposed to any intervention of any kind, and had seen this appreciation in the dollar take place with no action of any kind, and it seemed to us that it was necessary to say, "Do this much and no less in this period."

Senator HEINZ. Does anybody want to tell me why there is no danger of overshooting the mark, either with Senator Bradley's bill or with Senator Moynihan's bill?

DANGER OF OVERSHOOTING IS MINIMAL

Senator BRADLEY. Let me respond in terms of the bill that I offered. In a world of floating exchange rates, as I think Senator Proxmire and other people said today, there's not supposed to be an appreciating dollar when you've got a $120 billion current account deficit. The argument is, if you flood the world with dollars buying goods and they became oversupplied, the value of the dollar drops. That isn't what's happening and it didn't happen because of capital inflows. In particular, not just capital inflows, but a halt in U.S. bank lending. So if you agree that's the problem I think you will agree that we offer a very measured approach. The danger of

overshooting is very small because it gives the Fed enormous range in deciding how many dollars it will sell. We require it to sell at least $3 billion per quarter in any quarter that there has been for the previous year a $50 billion trade deficit.

Now if you were going to sell dollars to put the current account deficit in balance, last year the sale of those dollars would have to have been over $100 billion. So the Federal Reserve under our approach has the flexibility to sell anywhere from a minimum of $12 billion to whatever it chooses as a maximum if economic conditions trigger our bill every quarter. Our bill does not overshoot because intervention is reconsidered every quarter.

And I would argue that you won't overshoot with the level of minimum intervention required.

Senator HEINZ. We'll come back to that later.

Senator BAUCUS. Mr. Chairman, on that point, any action taken involves a risk. It's our view that doing nothing involves a greater risk. Also, I don't think $30 billion is very much in 3 years when it comes to the capital transfers in the world today.

Senator HEINZ. You've anticipated my last question which is this. Everybody, both here and down there, has made much of the fact that capital flows dwarf trade flows. Indeed, annual capital flows are somewhere beyond $20 trillion a year, maybe $30 trillion—somewhere in that range—$20 to $30 trillion. We're talking about—and both of you have legislation that over a 3-year period is somewhere in the $30 to $35 billion range—therefore, $10 to $12 billion a year—you are talking about, if you believe as I happen to believe that about half of those international capital flows are dollar denominated capital flows, you're talking about a drop in the bucket.

And the question I really have for you is, if we were to enact your legislation, why should we think it would make any difference?

Senator MOYNIHAN. Mr. Chairman, because it declares a different attitude upon the subject than the one that has been in place during which we've had this run up in the dollar's value.

Senator HEINZ. So the psychology is paramount?

Senator MOYNIHAN. Yes.

Senator HEINZ. Senator Bradley, do you agree?

Senator BRADLEY. I would agree that psychology plays an important role. I would also state that I think the Government has the responsibility to set the terms of the debate. You will hear people ask how can this small intervention, whether it's $12 billion a year or $30 billion over 3 years or whatever, have any effect on a currency market that trades $150 billion per day?

Well, the answer to that is you're not trying to offset all the capital flows in the world in a single day. A lot of those flows are five or six or eight trades in the same day. A lot of those dollars are sales to finance real trade and what you're simply doing by saying you're going to intervene is setting the tone, setting the direction, topping off the excess. And it's my own personal conviction that once that is done, speculators will take the movement in the direction that the Government has set.

Now some will try to speculate against the movement, but they would be speculating an unknown at that point because there is a coordinated commitment to intervene on a selective basis.

So my point is, Government has the responsibility and can affect the market because we're talking about affecting attitudes at the margin, and I believe that it is certainly, given the present state of our economy and our trade deficit, worth attempting.

Senator HEINZ. Thank you, Senator Bradley.

Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

I wanted to echo the chairman's comment. This has been one of the most clear and cogent explanations I have heard of the problems that we have with the overvalued dollar and what led to it.

I have a feeling almost of deja vu here. A few weeks ago Mr. Sprinkel came before this committee for his confirmation as head of the Council of Economic Advisers and I queried him closely at that time about the possibilities of currency intervention and what could be done to lower the value of the dollar. And he replied that that was hopeless, that the torrent of dollars, the torrent of currency transactions was so monumental that we could have no impact on it even if we wished to do so. And lo and behold, on September 22, the announcement comes that for the first time since 1973 when the world's currencies were left to float, to seek their own value, the United States has orchestrated an international effort to intervene in the currency markets.

This is similar to the administration's attitude, I might say, on their earlier efforts to scrap the Export-Import Bank, a program I happen to think is very important, that we've fought for, as Senator Moynihan and I did in the Budget Committee. All the while the administration was exerting enormous force to try to stifle the Export-Import Bank and, lo, just recently the administration now has discovered that a war chest for export subsidies might not be such a bad idea.

I'm reminded of an old law professor of mine who, I might say to Senator Moynihan, was a former dean of the Harvard Law School. He came to Vanderbilt University to teach evidence after he retired from Harvard, and we used to talk about the problems of inconsistencies. He would answer: "Young man, don't worry about the inconsistencies. The reason the dinosaur is extinct is because it couldn't turn around fast enough."

PSYCHOLOGICAL IMPACT OF INTERVENTION

Well, that's obviously not going to happen to this administration. I think it was long overdue for there to be some intervention in the currency markets to try to drive down the overvalued dollar. When my distinguished friend from New York brings up the name of a great firm from his State, Kodak, I would point out that Eastman Kodak is also the single largest civilian employer in the State of Tennessee. So I have an interest in seeing that that firm does have the ability to compete internationally and I suspect, Mr. Chairman, that these distinguished Senators are correct when they say that probably the most beneficial impact of attempted intervention or intervention would be psychological.

Do you want to respond to that, Senator Moynihan?

Senator MOYNIHAN. Well, Senator, I simply agree. The expectations engendered by the doctrine Mr. Sprinkel presented in 1981—and held with for 4 years until yet another calamity came about—led to certain calculations by private individuals that I don't think are to our advantage.

I would make this other point—don't underestimate the possibility of a collapse. I mean, Senator Baucus and I have said that we want strategic reserves to work both ways. We think the problem is bringing the dollar down; but if we look up one morning and it's falling in London and it's falling in Tokyo and it's collapsing in Geneva, and you've just got a panic on your hands, then you could use reserve currencies to support the dollar. Something this high is unstable I think. I don't know whether Bill Bradley or Max Baucus agree.

Senator BRADLEY. Well, I would respond and just echo what Senator Moynihan has said. There is incredible financial instability out there and while my first choice would be to have a firm, well-established, well-understood, coordinated intervention policy of the major 10 central banks that worked exceedingly well on the premise that other banks have more yen and marks than we would ever have in a strategic capital reserve absent that kind of cooperation, I think it is only prudent to have a pool of currencies that we could use in the event of a rapid drop in the dollar.

Senator BAUCUS. I might add, though, that what we're saying is we are going to do something. We're not just going to sit on our hands. And because we are still the largest, strongest country in the world, that in itself is significant.

Second, I think that we're saying we are not going to wait for others to act and depend solely on them. I often think that the wisest policy is to take the first step. If you want somebody else to do something, often you should take the first step to show good faith. The other party may then go along.

Enactment of the bill would be a major statement by us, and I think that can only be salutary.

Senator BRADLEY. If I could just follow once more. It seems to me that you have an extremely weak financial structure. You have the potential of very volatile shifts. And the reason you have a weak financial structure is there has been a deep erosion of the value of all collateral—land, the basic cause of the farm crisis, real estate, oil—and in such an atmosphere where I believe there are powerful deflationary pressures at work in an atmosphere of great financial fragility, that in answer to the question that you didn't ask, Mr. Chairman, the risk of inflation——

Senator HEINZ. I asked the question; I just asked you to defer answering it.

Senator BRADLEY [continuing]. Is minor compared to the risk of not getting control of the value of the dollar, and the powerful pressures that it generates within our economy, further weakening our financial structure.

Senator SASSER. If I could just ask one final question before concluding, Mr. Chairman—and this is a question that I think I propounded to Mr. Sprinkel—even if intervention doesn't work, what have we lost by trying? In other words, if we would agree that

something must be done, if we would agree that we've got a 50-50 chance of this approach working, what have we lost, if we attempt it and it does not work?

Senator MOYNIHAN. Nothing.

Senator SASSER. Well, gentlemen, why don't we do it? There is no reason not to. Is that the answer?

Senator BRADLEY. The only reason we don't do it is because we don't have 51 votes right now. Hopefully we will.

Senator SASSER. I will just conclude by saying this. I don't think the scenario of a catastrophic collapse in the value of the dollar is overstated. I was reading the other day where Gerald Corrigan of the Federal Reserve told the chief financial officers of the American Bankers Association that he thought that by the end of this decade we would have a net foreign debt of $500 billion. Some figures show that the United States could become a net debtor to the tune of $350 to $400 billion as early as 1987. We have in fact imported capital from abroad this year at times at the rate of 3 percent of our GNP, a rate three times higher than any time since the Civil War.

Given that scenario, given the fact that our balance of trade continues to worsen, given the fact that some economists say we're observing the deindustrialization of the United States, I don't think it's an exaggeration to say there is a substantial risk that we could see a catastrophic collapse of the dollar in the not too distant future. Thank you, Mr. Chairman.

Senator HEINZ. Thank you, Senator Sasser.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

I appreciate the testimony of my colleagues and I think it's valuable that we have this record to work from in terms of deciding exactly what the nature of our problem is and how we can best solve it.

LOW SAVINGS RATE

In the last few days news stories have indicated that the savings rate in the United States is now the lowest it has been since we have recorded the statistics and at the same time that the savings rate for individuals has dropped to this all-time low rate, consumer debt is higher than it's ever been, and it's not surprising that you not only see that pattern in consumers being extended out to their outer limits and maybe beyond but the Government and much of the rest of the world as well.

The Reagan tax program of 1981 was supposed to solve the problem of savings rates and drive up saving and foster a whole cycle of new investment and productivity improvement and so forth. We've seen very little of that. As a matter of fact, now we find ourselves with the lowest savings rate ever in modern times.

What I'm wondering is, with the U.S. spending binge we're on as individual, leveraged buyouts on the corporate side, the overspending by the Federal Government itself with record Federal deficits, aren't we going to continue to have to literally draw capital from around the world in enormous amounts and to pay whatever we have to pay to get it? And if that means interest rates have to go

higher differentially vis-a-vis what's available in other countries, then we're going to take the interest rates up as a nation simply because we're caught in a credit crunch, we're hooked on the need for foreign money in such enormous amounts that over any reasonable timeframe we're not going to be able to avoid that requirement. As a result, whatever we have to pay to get the money, we're going to have to pay to get the money because we can't afford not to have it. There are other reasons why money flows into the United States in addition to just our interest rates, but we're offering differentially higher interest rates than most other places and that's certainly had a bearing on it.

What I'm wondering is this. We can talk about currency differentials and we can talk about an overvalued dollar and clearly it is overvalued if you look at the relative currency value relationships of other countries, but as long as we're so overextended in terms of our need to consume capital and our insufficient national savings rate, doesn't that in a sense lock us into a situation where we're going to have to go out and extract enormous share of growth capital and draw it in here for these variety of purposes in a sense regardless of any other factor? Aren't we now to a point where unless we can somehow get things in entirely different kind of order that is really an inescapable fact of modern life? Senator Baucus, how do we deal with that?

Senator BAUCUS. Well, I think you put your finger on a real problem here. We are addicted to foreign capital. It's helping us to postpone a day of reckoning in this country. We're living on borrowed time.

And you're right about the low savings rates. The figure I saw is 1.9 percent in August, the lowest in modern times.

Senator RIEGLE. Since we've been keeping the statistics apparently.

Senator BAUCUS. That's correct. We must restore our basic competitive position. It's going to take hard work. It will mean changing laws—both tax laws and others—to encourage more savings and more investment in this country. Today we're subsidizing borrowers, and I believe that's one reason why we have such a low savings rate in this country compared to other countries. It will mean better education in this country. It will mean hiring better teachers. We have to do many things but I think the underlying point is restoring America's competitive position.

Senator RIEGLE. I agree with that. The problem with that is that's a longer term proposition?

Senator BAUCUS. It is long term.

Senator RIEGLE. We're working on it and gains come slowly. But at the same time you've got other countries that are surging because of things that they're doing intelligently in their economic systems, and it seems to me that as long as we're in this bind that currency intervention in any form may in fact be a delusion if we think that does anything more than give us a very, very temporary kind of response. It seems to me what is bound to happen, if you take and go through any kind of mechanism—Bradley mechanism or any other mechanism—to try to find a way to realign currencies through additional devices, that our insatiable appetite for capital inevitably will mean that we're going to have higher interest rates

which will mean inevitably that people are going to want to be in dollar assets, other things equal, because of the fact that we're having to pay these interest rate premiums in order to gorge ourselves on a disproportionately high share of available world capital.

I think the basic answers are the only answers. The Wall Street Journal today is pointing out that the present currency intervention program seems to be failing. I trust you've seen this, but the headline is, "Many Traders in Japan Think Efforts to Lower the U.S. Dollar May Fail." And the story goes on in this vein, that basically there's enormous rising skepticism as to whether this intervention program is going to work because the fundamentals are out of line.

So what I'm saying is, I'd like to hear a convincing argument that says that some way or another there's a way for us to get around the inevitability of high U.S. interest rates coming off our savings deficiency and therefore our capital appetite that in effect are going to take and misalign the currencies, no matter how much we manipulate the currency differentials, they're going to be wrenched back out of line by this other set of factors.

Senator BAUCUS. There is no easy answer. We need higher personal savings rates and a lower Federal budget deficit.

Senator BRADLEY. If I could, Senator Riegle, the implication of your question is we'll have to have high-interest rates to suck in currency or capital from around the world because we have an inadequate savings rate. If you look at the capital inflows into the United States over the last 3 or 4 years, they're basically steady. They haven't increased. They're about $90 to $100 billion. It is capital outflows that have dropped, primarily U.S. bank lending, between 1982 and 1985, which dropped from $120 billion to about $20 billion. It is that fact that I believe is in part responsible for where the dollar is, combined with the trade deficit.

On the savings question, I have been looking at the savings statistics—we have remained relatively constant within a band of personal savings rates. They haven't dramatically increased, somewhere between 4 and 7 or 4 and 8 percent, in that area, in times of recession and in times of boom.

NATION IS HOOKED ON EASY CREDIT

You ask, where's the free lunch—how do we manage this? I think what's happened—and I would have to get all the statistics to back it up—is that if you have an inadequate savings rate (and the ultimate example of inadequate savings is a gigantic Federal budget deficit), while credit expands dramatically, as it has in the last several years—personal credit, foreign debt et cetera—so people are becoming, individually and as a nation, more and more hooked on credit, then at some point the underlying financial structure becomes so taut, so fragile, that some exogenous event somewhere leads to its collapse. The longer term question is the question of getting the deficit back into balance in some way. I think we must improve the tax structure so that we have a more efficient economy. I think that in that kind of an atmosphere where you are addressing fundamentals that intervention can play a very important role in sending signals to the market about where

the Government will move and where it won't move. But intervention does not answer the total question.

I'd like to make just one other point. If the problem is indeed a problem of net capital inflows into this country, then there is a difference between sterilized and unsterilized. When you deal with sterilized intervention, what happens? You have the Treasury or the Fed sells dollars and then immediately issue a bond that sucks those dollars back in. So you offset the intervention. You're not really affecting the value of the dollar. Whereas, if you conduct unsterilized intervention, you don't have that offsetting bond purchase. Not only do you affect market psychology clearly, but you also have a real effect on net capital inflows.

So the reason I called for unsterilized intervention is that it has the double effect of affecting psychology and actually affecting the numbers in the net capital inflow category.

Senator MOYNIHAN. Mr. Chairman, could I just end on the note I began and very briefly and succinct to say that we leave you with perhaps more questions than we have answered, and I would say to Senator Riegle, don't underestimate the simple signals about doctrinal views that will come out of this committee.

We mentioned the savings rate. The savings rate today is about exactly where Franco Mogliani predicted it would be in his paper which he wrote at Bard College in 1946, having come here from Italy and for which he received the Nobel Prize 2 weeks ago. He said, "As social insurance and other arrangements grow, savings will decline."

Four years ago, we had a group of people who came in here and said, "Nonsense, what does Franco Mogliani know? Supply-side economics will take the savings rate up to Japanese levels and beyond in 14 months."

Well, they're back down to historic lows and what has come to change is a kind of doctrinal blindness and presumption that has got us in 4 years into the situation we can't even explain to ourselves, much less talk our way out of.

Senator RIEGLE. I just want to make one final comment about it and that is this. I can see the value of intervention to try to deal with misalignments of currencies that are as exaggerated as we have today and we're trying some traditional methods now and some suggestions have been made here of some different mechanisms that would enable us to do this.

The point I would make to the three of you is this. I think the fundamental problems are so serious and so aggravated and so long unattended to now that work on currency differentials by itself I don't think gives us very much bite, and I don't think we fool many people very long in thinking that that's the case. I think the international financial world is very sophisticated. They see all of our fundamental problems. They see through things like our recent balanced budget elixir that we just sent on through the Senate and other things. And with so many of the fundamentals sitting the wrong way, it seems to me that we're not going to make any major changes by finding cleverer ways to deal with currency alignment issues. If we don't have a strategy—a comprehensive national strategy for dealing with the fundamentals that are out of line—savings rate, productivity improvement, high Federal deficits, overall credit

extensions being beyond what they properly should be—and if we don't deal in some coherent way with all of those things at the same time, I think that what you do in terms of then just trying to intervene with currency differentials really is something of a fiction. I mean, I'm not against doing it. I'm simply saying that that isn't going to change anything for very long.

Basically, I think the speculators feed on that. I think they will clean up in a situation like that because we're holding a weak hand. The only way you hold a strong hand is if you start to do the kinds of internal things in terms of the tough disciplines that are needed that really start to make a fundamental difference. I don't hear any conversation on that, frankly—very little—in terms of that laundry list of problems. I know industrial policy is a phrase we can't use any more, but whatever we're going to replace it with is the kind of concept that also is going to have to be looked at along with these other things that I mentioned here.

Senator MOYNIHAN. I agree.

Senator BRADLEY. Mr. Chairman, I would agree with what Senator Riegle said in general terms. I would simply make the point that intervention is the only short-term response that you have. Deficit reduction, Latin American debt, all these other fundamentals have to be changed. That's not going to happen now. You can intervene now or refuse to intervene and subject yourself to yo-yo exchange rates and misaligned exchange rates that do not reflect the real world.

Senator HEINZ. The Chair would announce that there's a vote taking place but he intends to call the next witness. Let me thank Senators Moynihan, Baucus, and Bradley for their excellent testimony and participation. We appreciate your attendance.

Our next witness is David C. Mulford, Assistant Secretary for International Affairs, Department of the Treasury. Mr. Mulford, you may proceed.

STATEMENT OF DAVID C. MULFORD, ASSISTANT SECRETARY FOR INTERNATIONAL AFFAIRS, DEPARTMENT OF THE TREASURY

Mr. MULFORD. Mr. Chairman, I have a short statement I would like to read, with your permission, and to submit my full statement for the record and then provide a brief oral review.

Mr. Chairman, members of the committee, I welcome this opportunity to present the Treasury Department's views on the important issues your subcommittee has under consideration. The G–5 announcement is important for several reasons. Most significant is the content of the announcement itself and its positive implications for future economic policies and performance. It will promote sustained growth and adjustment of external imbalances among our countries. The announcement also reflects close cooperation and consultations among the major industrial countries.

Along with the President's trade policy action plan and our initiative in Seoul on the international debt strategy, it constitutes a key element in our efforts to address current international economic problems and their effects on the U.S. economy.

I will focus on three features of the announcement in my testimony.

First, it draws attention to changes already occurring in economic fundamentals here and abroad. It affirms the strong prospects for continuing favorable changes; and third, it outlines the intentions of the G–5 governments to pursue additional, specific policies to sustain and accelerate the changes in performance.

HISTORY OF PRESENT DEFICIT PROBLEM

It is important to examine how the large current account deficit and strong dollar developed. In 1980, the beginning of sustained dollar appreciation, the United States had a merchandise trade deficit of $26 billion; the current account was in surplus by $2 billion. Over the period 1980 through 1984, the trade deficit grew, reaching $108 billion on a balance of payments basis last year; the current account shifted to a deficit of $102 billion. The dollar appreciated 41 percent on a trade-weighted basis against the major G–10 foreign currencies, and peaked against them on February 26, 1985.

Underlying this deterioration of our external accounts—and the strong dollar—were two fundamental factors: first, strong economic performance in the United States relative to other major industrial countries; and second, the LDC debt situation.

You are all well aware of the vigorous U.S. expansion and our strong gains in employment since 1982. The performance of our trading partners, however, was relatively weak over this period. For example, our GNP in the fourth quarter of 1984 was 12 percent higher than during the recession's trough in 1982. Real GNP in the other major industrial countries rose only 7 percent over the same period and, in Europe alone, only 4 percent. This was a reversal of historical trends.

U.S. inflation also improved markedly falling from 13.5 percent in 1980 to about 4 percent in 1984, while inflation in the major European countries fell from 13 to 6 percent.

Economic policies pursued by the administration and Congress over the past 5 years are the reason for strong U.S. performance. Anti-inflation efforts, deregulation, tax reductions, and a shift both in attitude and behavior toward free markets stimulated investment, increased rates of return to entrepreneurship, and helped create over 8.5 million jobs during the current expansion. In contrast, European growth and job creation have been hampered by policies that have limited their economies' ability to adapt to changing economic circumstances. Europe lost over half a million jobs during 1982–84, despite positive growth.

The differences in performance have had a strong impact on the trade balance and the dollar. Relatively stronger U.S. growth resulted in sharp U.S. import growth and weak export growth. Our weak export growth to Japan has been due in part to the closed nature of Japan's tradeable goods sector. Net capital inflows—reflecting investors' preference for dollar assets due to our strong economic performance—contributed to the appreciation of the dollar.

I mentioned earlier that the LDC debt situation was also a major element in both our trade deficit and the strong dollar. As LDC ex-

ternal and domestic economic conditions deteriorated, their economic growth fell sharply. Our exports to Latin America fell $16 billion between 1981 and 1983. Although we recouped about $4 billion last year, our exports to Latin America still were $12 billion below the 1981 level.

Senator RIEGLE. Excuse me just 1 minute. I apologize for interrupting and I'm caught in a dilemma where we have a vote underway and where we're rotating to try to get to the vote and return and then none of us miss the vote. The second bells are ringing. What I'm going to ask you to do, if I may, is to suspend at this point and we'll stand in recess briefly until presumably Senator Heinz returns, so that I am able also to go and vote, and then hopefully we will all be back here for the question period so that we'll have a chance to engage in it. I certainly have some that I would like to raise.

So with that comment, let me put the subcommittee into recess I would hope for a matter of maybe 5 and no more than 10 minutes, and then we will resume at that point.

[Recess.]

Senator HEINZ. The subcommittee will come to order.

Mr. Mulford, I want to apologize to you for having to go and vote. I am not unfamiliar with your statement. We received it last night and I had a chance to read it. I don't know whether you've completed your remarks or not.

Mr. MULFORD. I have not, but I am happy to discontinue the remarks if you wish and simply answer questions.

Senator HEINZ. Or if you want to just summarize briefly the remainder of your remarks, as you will. How far have you gotten, if I may ask you?

Mr. MULFORD. About halfway through.

Senator HEINZ. Well, I'll tell you. I'm concerned that we're going to get interrupted by more votes and perhaps it would be best if we put the rest of your statement in the record and proceeded to questions, and that will also I think be to the advantage of the last panel of witnesses.

Mr. MULFORD. Fine.

Senator HEINZ. First of all, as you point out in your statement, you have been very much involved in that September 22 G–5 meeting. There have been some analysts who said, particularly viewing subsequent events, that that was really much ado about nothing. They said that those communiques and commitments—and I read them and I must tell you they were pretty broad and general—were so vague as to be meaningless. I wouldn't go that far but a lot of analysts and critics have.

SIGNIFICANCE OF THE G–5 COMMUNIQUE

What is there of significance in our—and equally, if not more important, the communiques of the other members of the G–5? Are there real policy commitments here or is it just more of the same that we have had before?

Mr. MULFORD. Well, I think one first of all has to say that the fact that the G–5 nations did come together as they did on September 22, and issue a statement as comprehensive as this one was was

significant in itself. This has not happened before. There have not been communiques issued before of this length or of this much substance. And the United States clearly took the initiative in bringing the group together and negotiating the substance of the statement in the period leading up to September 22.

The statement has in it a strong view which is that economic fundamentals have already begun to change quite substantially in the other countries, that these changes are expected to continue, and finally, there is the statement backed up by policy intentions expressed in the attachment to the statement that the broad policies being followed will continue to be followed and certain specific policy actions are indicated for the future.

For example, Germany makes a clear statement that in addition to the tax cuts that it is instituting in 1986 and 1988, it will continue to examine tax reform. We know that they have in mind laying before their electorate in the next election campaign more detailed plans for tax reform.

In Japan, there's also a clear indication, which was not in the statement but which was made the same day the statement was issued by the Prime Minister and confirmed by the Minister of Finance, that they too have started a tax reform procedure which will take some time. But Japan also indicated that it would have certain stimulative measures to announce. They have since been announced that have to do with encouraging consumer credit use, development of a mortgage market, and incremental local authorities spending and investment, which in Japan is an important guide to economic activity.

We believe that these measures in Japan, for example, will contribute to GNP growth at some rate which is hard to be precise about. They have indicated a 1.3-percent increase in GNP over the next year. We are not sure it's that high but we are sure there will be an increase.

So without going through each country and giving you a detailed account of each country's statement, we believe there are very significant statements here that will affect future economic activity.

Senator HEINZ. Then what would be wrong with the statement, as you have described, that these economic fundamentals have already changed—certainly since the September 22 meeting there have been a general strengthening against the dollar of the deutschemark, the yen, the SDR, the European currency unit. The dollar has dropped in relation to all of those anywhere from 4.6 to 9.5 percent.

What about those people who say, well, maybe you're right; then maybe that meeting didn't have any significance at all; those fundamentals had already changed?

Mr. MULFORD. Well, I think, to try to put this in perspective, it's important to go back just a little bit in time.

It's clear that by May or June there were beginning to be evident certain positive economic developments in countries outside the United States in the G–5 group and these were not, we believe, being seen fully in the market. It's understandable because Japan and Germany, for example, both had very negative first quarters this year and then came back very strongly in the second quarter. Those numbers weren't really visible or reported until well after

the end of the second quarter. But it was clear that growth in Germany and Japan, to take two examples, for 1985 is picking up very sharply. That's point No. 1.

Point No. 2 is, there is a stronger domestic content to their growth—very important, because it means that their growth is less export-led than it was previously.

Over the summer there were other important changes taking place. The Federal Reserve in the United States rebased its monetary statistics. A budget deficit package was passed by the Congress. And perhaps most importantly, the dollar had come off its peaks and begun to show in the exchange markets that it was capable of moving both ways and not simply in one upward movement as had been the pattern for some months and indeed years before that. So that we felt we were looking at a changed situation.

There was a desire on the part of the Treasury to be responsive to the rising protectionism that we sensed was developing on the Hill and you will notice in the statement that was issued in September a very important conclusion which was that changing economic fundamentals had not at that time been fully reflected in the exchange markets and, further, a statement by the Ministers that it was agreed that the nondollar currencies should appreciate relatively against the dollar.

INTERVENTION IN THE CURRENCY MARKETS

Senator HEINZ. One of the things you really don't touch on much in your statement or was really not referred to much in the communique is intervention in the currency markets.

Is intervention an absolutely useless tool?

Mr. MULFORD. Well, there is a sentence in the statement which conveys the impression certainly to the markets that there was agreement that coordinated intervention, as has been stated since the Williamsburg summit, is a policy tool that is available and from time to time may have a use or may be helpful or may be appropriate. That wording has appeared in a variety of different communiques and it appears, as well, in this communique. And the market took that to mean that there may well be intervention in the period that followed the meeting in New York and indeed there has been intervention on a number of occasions.

Senator HEINZ. By us, by the Treasury?

Mr. MULFORD. By us, included. But we have a policy, as you know, of not commenting in detail on our plans for intervention, the magnitude, the frequency, et cetera but we do, as you also know, make a regular report to Congress on intervention activities and these materials have been flowing up here and will continue to flow and the picture will emerge over time on a confidential basis to you.

Senator HEINZ. Do you believe that the dollar is overvalued?

Mr. MULFORD. Well, that's a very difficult question. Obviously, at the time that the meeting took place we clearly felt that the dollar was overvalued at that moment in the markets.

I think it's important to realize that the value of the dollar or any currency at any given time is a product of a myriad of fundamental economic facts on the one hand, and also the perception of

those facts in the market by all market participants on the other hand.

Clearly, following the September 22 meeting, there was a very sharp shift in exchange rate values which has tended to stabilize at the levels that we are looking at today which in the case, for example, of the deutschemark has involved a move since the time of the meeting in New York of about 8½ percent; in the case of the yen, about 11 percent; and there appears to be in the market a searching for a new level of exchange rate relationships.

Senator HEINZ. Well, is that to say that you believe that that relationship has been found or that the dollar is still overvalued?

Mr. MULFORD. I think it's very hard to say. I would say that the present——

Senator HEINZ. What you're saying is you don't want to second-guess the market?

Mr. MULFORD. Well, what I don't like to do is use the word overvalued. Let me put it a different way.

Senator HEINZ. OK.

Mr. MULFORD. The economic fundamentals that we see in progress today and which we believe we will continue to see over the next months would suggest that these currency changes that we have seen are likely to continue.

At this particular moment I don't know whether the dollar is overvalued or not, but it would not surprise me, given what we see in the economic area in the various countries, including the United States, to see the dollar decline somewhat further in the future. That would not surprise me.

I am not saying I think it's overvalued at this moment, but I think there's little likelihood, given the economic facts we're looking at, that it will appreciate strongly again.

Senator HEINZ. The subcommittee has before it two bills, Senator Moynihan's bill and Senator Bradley's bill. I think you're familiar with the general terms of those bills.

Mr. MULFORD. Yes.

Senator HEINZ. Do you believe that enactment of either of those bills would be positive, would be helpful, or would you view them as counterproductive? How would you view those bills?

Mr. MULFORD. Well, first of all, I believe that the two which were proposed in July, as I remember it—incidentally, the very moment or even perhaps slightly after the moment that we had begun our negotiations for the package that we eventually produced—I believe both bills have been overtaken by events in effect. We have signaled at the end of September an important shift and there has been activity in the markets—intervention activity—and I don't think it's realistic to look to a highly formalized, highly detailed procedure for intervention which makes it automatic or defines the amounts that are to be used, et cetera.

I would call it a rather academic approach and I would suggest that any of the proposers who cared to spend some time dealing in foreign exchange markets with their own money would find out very soon that their approach is impractical and unlikely to be effective.

I also think it's possible that by having a highly visible approach which leaves very little discretion to the Treasury, for example, or

to the Fed, that the likelihood is that the markets would take very substantial advantage of us and it would be at our expense that those activities were undertaken.

NEED FOR COORDINATED INTERVENTION

I think coordinated intervention—and I emphasize coordinated, not just U.S. intervention but coordinated—among major countries around the world does from time to time have a role to play, but its role is not an answer in and of itself. It must be combined with other policy actions that change or affect the economic fundamentals.

So as they stand, as single pieces of legislation, unrelated to coordinated intervention and unrelated as I see it to fundamental policy reform here and abroad, I think it's unlikely that they would be effective.

Senator HEINZ. Thank you, Mr. Mulford. My time has expired. Before I yield to Senator Sasser, I just want to express my appreciation to Senator Riegle for having chaired the hearing in my absence and I'm sure he felt glad to be chairing the hearing again.

Senator RIEGLE. A fleeting moment of power remembered.

Senator HEINZ. Senator Sasser.

Senator SASSER. One question, Mr. Chairman.

Mr. Mulford, in analyzing the reason for the dollar's spectacular rise during the period from 1982–84, in reviewing your statement you made virtually no reference to the fact that the effect of high interest rates in the United States compared to those of our major trading partners. During this period of 1982–84, I'm advised that real short-term interest rates in the United States averaged 6 percent. In Japan, Germany, United Kingdom, and France, the average real short-term rate was only 3.9 percent. In other words, real interest rates during 1982–84 were about 50 percent greater here in the United States than the rates of our major trading partners.

You're not suggesting to the subcommittee that this substantial difference in interest rates has no effect on the value of the dollar and the resulting trade deficit, are you?

Mr. MULFORD. Well, let me put it this way. As a practicing investment banker with 20 years in the international financial markets, I am perfectly aware that interest rate differentials from time to time play a role in the decision that investors are making and that traders are making in the markets.

But on the other hand, the facts are very clear that during the period you mentioned—and I don't have those numbers in front of me—that we saw a number of developments on the interest rate front which were entirely inconsistent with the theory that interest rates drive the value of currencies.

For example, nominal dollar interest rates fell very sharply from 1981 through 1984, the very period that the dollar was strengthening. Second, real dollar interest rates have also come down and in some cases they have come down more rapidly than have the real rate levels in the nondollar currencies. And still the dollar was strengthening. Third, if we look at interest rate differentials between the various currencies, which is often what traders are looking at, during that period 1981—and I have statistics and can send

them to you if you wish—the pattern is clear that there is a decline in interest rate differentials that run against the dollar during the very time that it was strengthening.

So I think it's fair to say that interest rate differentials, real interest rate levels, and the movement of interest rates in general day to day, can have an effect on currency movements but it is not a direct and correlated and constant effect. There are other factors that affect exchange rates. Interest rates is one of them and even that is not constant.

So I think it's a highly complex area but you cannot draw the conclusion that interest rates drive exchange rates.

Senator SASSER. I'd like to pursue that, Mr. Chairman, but I'm not going to be able to remain for the remainder of the hearing because I've got a conflict. Thank you.

Senator HEINZ. Thank you, Senator Sasser.

Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

You were here earlier to have a chance to listen to some of the exchange with the three Senators who appeared as witnesses and I want to follow along the lines of some of that discussion.

CRITICAL ISSUES TO BE DEALT WITH

Let me tell you the reaction that I'm picking up as a result of the announcement of the G–5 Finance Ministers and the reaction to the administration's proposal regarding the IMF and World Bank, all of which I think has been mixed—positive in the sense that the Treasury has finally recognized in a very visible way that there are some very critical issues that need to be dealt with, but I think there's been a lot of reaction that's been negative in the belief that the administration is focusing too much of its attention and its efforts on secondary solutions rather than fundamental solutions.

Let me try to summarize what I'm hearing as the central issues here that we may not be getting at. Let me just cite some facts here that are very troubling and that make this point.

In each of the past several years debt in the United States—and I'm thinking now of overall debt—has risen markedly faster than GNP and that if we had a straight extrapolation of recent trend lines over the next decade it would suggest that by 10 years from now, 1995, we would have about $2.25 debt for every $1 of GNP.

If you look within that debt pileup at the Federal component of the debt relative to GNP, which has been on a pronounced downward trend over most of the postwar period, it has now reversed that and is rising very rapidly. In fact, for 1985, Federal debt will amount to almost 40 percent of GNP.

For the private sector as a whole, the ratio of debt to GNP is at an unprecedented level and is still rising. Furthermore, the recent spurt in private debt accumulation has to a large extent occurred on the upside of the business cycle and the downside of the nominal interest rate cycle and despite what are generally seen as relatively high real interest rates.

At this juncture, it's difficult to foresee circumstances in which the foreign debt of the United States will not approach $500 billio

by the end of the decade and this is the figure that's now been put out and mentioned earlier today. Indeed, some have suggested that we would be lucky if the figure were not larger than $500 billion by 1990.

In considering the possible implications of external debt of this size, there is at least a question as to whether foreigners will be eager to continue to accumulate dollar denominated assets at those amounts even if we were at current interest rates, not to mention the possibility of lower interest rates. That gave rise to my point earlier about the fact that it seems to me we've built ourselves into a box where we're going to have to have differentially higher interest out in the future just to be able to keep this enormous load of debt up there and able to roll it over, able to keep it churning.

We also have a Tax Code—and some have mentioned this today—which in certain instances has strong incentives that favor debt accumulation.

So, I try to assess everything that I'm reading and hearing in the way of overall financial market and professional reaction to the administration's recent initiatives, I'm hearing very muted applause, if you will, and more and more an underlying tone of concern that this is not a sufficient policy, that this is more a kind of surface policy and that the fundamentals that have helped create the problem are very badly out of line and that next to nothing is being done to deal with those problems.

I'm just wondering what your reaction is, as specific as you can make it, to those who say that the policy is ignoring the fundamental problems that lie under what has driven these currency differentials to take place?

Mr. MULFORD. Well, on the question of U.S. debt, I think it's clear that our position has been and remains that there's too much debt; it's risen too quickly. That is a function of the deficit problem that we have.

We have made some progress on interest rates in this country. We have not made enough progress on the deficit, and we have for our own domestic reasons in the United States a great necessity to address that problem, and I believe Gramm-Rudman, for example, is evidence of that, that there's a rather overriding need which is sensed by more and more people that this is a problem which has to be addressed.

COMMITMENT TO DEFICIT REDUCTION

I think it's probably less significant whether the debt for the moment is financed within the United States or externally. I think that's a secondary question. But we have acknowledged long ago that the deficit is too large. It's a problem that has to be addressed and we have attempted to address the problem and the G–5 statement makes it clear in the U.S. section that we will continue efforts to reduce Government expenditure as a share of GNP in order to reduce the fiscal deficit and to free up resources for the private sector, to implement fully the deficit reduction package for fiscal year 1986. This package which was passed by Congress and approved by the President will not only reduce by over 1 percent of

GNP the budget deficit for fiscal year 1986 but lay the basis for further significant reduction of the deficit in subsequent years.

There's a strong commitment there. There's a strong statement, and we fully intend to do everything we can to carry that out.

Senator RIEGLE. Is that basically it? I mean, is that the extent to which we're really going to tackle the problem?

Mr. MULFORD. Well, in your question I think you were saying, were you not, that somehow intervention was no substitute for getting at the fundamentals? Was that not the thrust of your question?

Senator RIEGLE. Yes, and the fact that I think there is an emerging body of professional opinion outside the Congress or our Government that is expressing that view, that if this is all we do or if the currency actions are a kind of veneer on top of fundamental policies that are working against our long-term purpose, that they're not going to have much of an effect for very long.

Mr. MULFORD. Well, I think that you were not here when I said, for example, that at the time that we put this package together we believed—and I think it's turned out to be correct—that the economic fundamentals are changing rather significantly in the United States and also in the other major countries.

Our economic growth, relative growth, for example, has moderated in the past year or so. Their growth has picked up. The balance, therefore, of growth between ourselves and the other countries is more balanced than it's been for some time. The balance of growth within the other countries between export-stimulated growth and domestic-demand-stimulated growth has also become better.

These are positive developments that had begun to be seen in the market and our statement brought the world's attention to them and indicated that we believed that they're an ongoing phenomenon. In other words, that these fundamentals are changing and they're changing in the right direction and we think the actions of the market since that announcement have in fact verified that judgment.

Now when we talk about major policy changes of the type that you've referred to, we know in our country how difficult these things are to do. They are just as difficult politically in other countries as well, whether it's tax reform, cutting deficits, whatever it happens to be.

There is this idea around, chiefly in the press, which one sees from time to time that somehow we just pick up the phone and ask foreign countries to jiggle their policies around a little bit so that we can start to change currency markets. It is not easy in any country.

Moreover, it takes time to accomplish complex changes in macroeconomic policy. To negotiate and then to implement tax reform, it takes time. The Japanese are going to take 1 year of study and 1 year of implementation. We've taken considerable time ourselves. The Germans have a plan which they estimate will take several years to put into place.

You can't change these things overnight, but markets anticipate and the exchange markets have seen I think that important changes are taking place and that things are moving in the right direction. Incidentally, the effect on us of these changes, the 10-per-

cent change in the exchange rates, for example, since the end of September, will factor through in a period of 1 year or 2 into our trade deficit figures and show some considerable improvement. Our estimate is that a 10-percent change in exchange rates would have an effect on our trade deficit, positive, of approximately $30 billion 1½ or 2 years out.

Senator RIEGLE. On that point—have you had a chance to read the feature story on the front of the Wall Street Journal today?

Mr. MULFORD. Yes. On the right hand side?

Senator RIEGLE. Yes.

Mr. MULFORD. I read that one, yes.

WALL STREET JOURNAL ARTICLE—SKEPTICAL OF PROGRESS

Senator RIEGLE. Well, I think it was a particularly well written piece, but about seven paragraphs down, after expressing basically a lot of skepticism as to whether this intervention program bites in sufficiently and whether or not it's likely to make any sustained difference, there is a summation paragraph that reads as follows:

Some people here believe that within a few months, the yen will return to the level of about 240 to the dollar, where it was trading shortly before the September 22 meeting in New York. Others predict that the yen will weaken only a bit and it will settle between 215—the current trading range—and 240. Few expect it to stay as strong as it is, let alone strengthen further, as the United States and Japanese authorities would like.

[The Wall Street Journal and New York Times articles follow:]

[From the Wall Street Journal, Oct. 23, 1985]

BUYING THE BUCK—MANY TRADERS IN JAPAN THINK MOVES TO LOWER UNITED STATES DOLLAR MAY FAIL

(By Christopher J. Chipello)

AT CURRENT LEVELS, THEY SEE GREENBACK AS A BARGAIN AND PURCHASE IT ON DIPS—BUT UNCERTAINTY STILL REIGNS

TOKYO.—Many foreign-exchange traders here think that for the time being, the dollar has dropped about as much as it is likely to. If they are right, it's bad news for the five major nations that a month ago agreed to try to improve America's trade position and curb protectionism by pushing down the value of the dollar in world markets.

"This is probably as far as intervention can take the dollar," Yukuo Takahashi, the foreign-exchange manager at Chemical Bank's branch here, tells a trading-company executive who called him up early one recent evening.

Leaning back in his chair in the nearly deserted office, Mr. Takahashi adds that the five nations' central banks, which have been selling dollars to lower their price, "have done well to bring it down this far. The market's been ignoring the fundamentals: The U.S. trade account is looking better, the American economy is doing OK. If the dollar goes down any further, I'd buy."

STEADY PERFORMANCE

There clearly are a lot of dollar buyers in the currency markets. A month after central bankers and finance ministers from Japan, the U.S., Britain, West Germany and France gathered in New York in an extraordinary effort to convince the markets that the dollar should drop, the dollar has been generally steady after an initial plunge. Whenever the dollar starts to rise, the central banks apparently intervene—selling dollars to hold down the price—but the underlying demand for dollars remains strong.

Uncertainty about what the central banks will do next—an uncertainty that the authorities consider perhaps their most potent weapon—has turned currency traders cautious all over the world. But, like Mr. Takahashi, many major players in the

Tokyo market are beginning to think that the stampede away from the dollar has run its course.

Some people here believe that within a few months, the yen will return to the level of about 240 to the dollar, where it was trading shortly before the Sept. 22 meeting in New York. Others predict that the yen will weaken only a bit and will settle between 215—the current trading range—and 240. Few expect it to stay as strong as it is, let alone strengthen further, as the U.S. and Japanese authorities would like.

"There is tremendous commercial demand for dollars in Japan," says Wayne Lochner, the managing director of Hatori-Marshall Co., one of Japan's eight licensed foreign-exchange brokerage firms. "Importers are going to be stocking up. They haven't seen these levels in years. It's really a sale day for them."

Even though the amount of foreign-exchange trading actually done here is relatively modest by money-center standards, the climate of opinion in Tokyo is important, given Japan's need for dollars to pay for imports of crucial raw materials, the growth of its export earnings from abroad and its huge accumulation of capital.

Although some observers say the five nations' move to manipulate market psychology may be losing its force, other analysts aren't so sure. They note that central banks have long sought to maintain orderly trading in foreign-exchange markets and that no one wanted the dollar to plunge too rapidly; so they contend that the dollar dropped to 215 yen in less than two weeks after the New York meeting and then has stayed there doesn't rule out further declines. They also say many Japanese traders have been buying dollars recently—and thus shoring up the price—for a transient reason: They fear the Japanese Government is about to impose further controls on Japanese foreign investment.

POLICY CHANGES NEEDED

But market analysts agree that if the intervention isn't followed by fundamental shifts in economic policy, the central banks will have poured billions of dollars into world markets in a futile cause.

"Everyone agrees that intervention alone can't stabilize the exchange rate," says a Bank of Japan official involved in the process. "In that sense, it's no surprise that the marketplace is beginning to think intervention's role is nearing an end in the current cycle."

Most analysts here doubt that the economic-stimulation measures unveiled by the Japanese government last week will do much to reduce Japan's trade surplus and bolster the yen for at least six months. Instead, they emphasize the importance of the U.S. Government's reining in its deficits and taking pressure off the Federal Reserve in its fight against inflation. Unless that happens, they say, U.S. interest rates may rise again. Meanwhile, with Japan's economy slowing down, the Bank of Japan is under pressure to reduce rates here.

Seeing high interest rates in the U.S. and little likelihood that the dollar will strengthen further, Japanese institutional investors may well start to stock up on dollar assets. Their buying would tend to bolster the value of the dollar.

Analysts here also doubt that President Reagan and Prime Minister Yasuhiro Nakasone of Japan will be able to deliver a strong message to the market after their scheduled meeting in New York on Friday.

"What can they do besides reaffirm their intention to intervene?" Mr. Takahashi asks. He adds that some life-insurance companies, which are among Japan's biggest institutional investors, "are saying they see the dollar as a risk-free investment at bargain prices."

If the dollar does strengthen again, the repercussions could be serious. Protectionist sentiment in the U.S., which may have ebbed a bit in recent weeks, could surge again, analysts say. And if the U.S. sharply restricts imports, the world economy would suffer severely, they add.

[From the Wall Street Journal, Oct. 21, 1985]

UNITED STATES-JAPAN SOCIETY CAUGHT IN CROSSFIRE OF TRADE DISPUTE

(By Mike Tharp)

FRIENDSHIP PANEL'S BUDGET SNARLED AS CONGRESS VENTS FRUSTRATIONS WITH TOKYO

During World War I, anti-German sentiment led many Americans to dine on "liberty burgers" instead of hamburgers, avoiding the term derived from the name of the German port city.

Now, with congressional resentment against Japan on the rise, comparable feetings plague the U.S.-Japan Friendship Commission, a group that is academically respected though not widely known.

A House Appropriations subcommittee, acting on a proposal by Rep. Richard Regula (R., Ohio), refused this summer to fund $2.7 million of the commission's $3.6 million budget for the fiscal year that began Oct. 1. The corresponding Senate committee left the appropriation intact, and the fate of the funds will be determined by a conference committee late this month.

The commission, which has offices in Washington and Tokyo, was formed in 1975 to strengthen the "long-term educational and cultural foundations" of U.S.-Japanese ties. Its activities have included sponsoring Japanese-language training at universities in both the U.S. and Japan for American students, arts and cultural exchanges and research grants. According to its supporters, U.S. businesses are among those benefiting from the commission's language programs.

"If Congressman Regula wants to compete with Japan, he needs the Friendship Commission," says Chalmers Johnson, a professor of political science at the University of California at Berkeley. "You can buy in English, but you can't sell (to Japan) in English," he says.

To pay for the commission's activities, Congress set aside an endowment denominated in both dollars (about $18 million) and yen (the equivalent of $16 million). The funds came partly from money paid by Japan to compensate the U.S. for postwar aid. Interest from the two funds can only be spent on the commission's activities, but the 1975 law still requires congressional approval of each year's appropriation.

Previously, this was a routine matter. But with the U.S. facing a $50 billion trade deficit this year with Japan, and with Prime Minister Yasuhiro Nakasone due to arrive in the U.S. this week to meet with President Reagan, the group has become a lightning rod for congressional frustration with Tokyo.

Commission members point out that cutting off its appropriations doesn't trim the U.S. budget deficit. They also note that Tokyo contributed an additional $2 million for grant programs in 1981. "The money just piles up in a bank account if we don't use it," one official says.

But critics such as Reps. Regula and Joseph Early (D., Mass.) object to a Japanese stipulation that Tokyo's contributions to the commission must be spent in Japan, and they question the use the group has made of some of its money.

"I don't think a performance of 'The Ugly Duckling' in Japan does much for U.S.-Japan relations, especially on the economic side." Rep. Regula says, referring to one of the cultural events the commission has sponsored.

Reaction to the cutoff generally has favored the commission. The U.S. ambassador to Japan, former Sen. Mike Mansfield, sent a letter to some of his ex-colleagues in Congress urging them to reconsider. BankAmerica Corp's vice chairman, James Wiesler, wrote that eliminating the commission's funds "will only increase the barriers between the U.S. and one of its most important allies."

The commission's defenders acknowledge that anti-Japanese feelings in Washington aren't likely to subside unless the trade figures improve for the U.S. But they hold out hope that the House will reinstate its funds if the Senate leaves the money in its appropriations bill.

"I suspect Regula and Early will grouse about it but give in," one congressional aide says.

[From the New York Times, Oct. 24, 1985]

UNITED STATES AND JAPAN TRADING VENTURE

(By the Associated Press)

Japan's largest trading company has joined an American venture capital firm in creating a $23 million limited partnership intended to promote exports of products from small and medium-sized American technology companies to Pacific Basin markets, company officials said. Officials of Vista Ventures U.S.A. and Mitsui & Company (U.S.A.) Ltd. said that the limited partnership—dubbed Orien I.L.P.—represented the largest pool of Japanese investment ever put together as venture capital for American companies.

Y. Sajima, Mitsui (U.S.A.) corporate secretary, said Japanese investors had put about 80 percent of the capital into Orien, which lists companies such as Bank of Tokyo Ltd., Shearson Lehman Brothers, the Standard Oil Company (Ohio), Mitsui and its American subsidiary, and the Nippon Steel Corporation as investors. While the capital itself would help the emerging companies get off the ground, Mitsui's expertise and position in the Far Eastern markets would aid their expansion, Mr. Sajima said.

Senator RIEGLE. I won't go into the rest of the piece. You've read it. But I think it's significant when we're getting a summary story in a publication like the Wall Street Journal that basically is expressing more and more skepticism as to whether or not what we've done here is anything more than—I don't want to say cosmetic—it's not cosmetic, but it's in a sense a kind of veneer on top of underlying problems which, as you say, there's a desire to do something about the fundamentals but there's precious little evidence that we're making any changes on the fundamentals.

Even Gramm-Rudman—which I happen to think, frankly, is a fraudulent legislative mechanism but even if you believe in it, there's no guaranteed deficit reduction there until you get out literally into the tail end of next year and then, of course, we may or may not get some depending upon how it works if it's enacted. But there certainly isn't anything that comes quickly from it, as Professor Modigliani and others have mentioned just this week, saying that if we're going to do something about the deficit it ought not to be in terms of some kind of formula that stretches out several years into the future but it ought to be something that's done now.

Is the administration proposing any kind of an immediate deficit reduction effort?

Mr. MULFORD. Well, let me address the question you asked about the Wall Street Journal first on several different levels. First of all, as a market person, my response to that article is that a lot of people in Japan are losing a lot of money and they want to talk the dollar back up again. They believe that they were caught. There are people around uncovered, for example, who would like nothing better and will talk that game whenever they get the chance. There are two sides to every market. There are people who think the dollar is going to strengthen further and there are people who think it's going to fall further and there are some people who are even worried about a precipitous decline.

I don't think we can take a single article recording the views of a few people in Japan with no idea about what their position was or is in the market and read that as a very significant conclusion by way of judgment of our program.

I think instead we have to look to some of the fundamentals. We have to look to the fact that in the last month there has been a

shift in rates of approximately 8 to 10 percent in the major currencies and those appear to be holding. The dollar weakened. It's come a little bit off its bottom, but that's normal too in any market, that you should see some range of trading activity.

So when the press says, well, you know, the dollar touched 210 against the yen and now it's 215, that's meaningless against a move from 240 to 210 where it touched for a few seconds one day at the bottom of its movement and where it's been trading happily at a range of 213 to 216 ever since. There's been no evidence in this case that the yen rate is going to return to 240.

Now the Japanese have indicated what their policy intentions are and they have since produced a package of measures which has in it at least three items that are new and that have been filled out since September 22. One of those is a consumer credit effort to increase the use of consumer credit. Two, is a measure to increase activity in the mortgage market, and three, is to increase activity in local government investment and spending, which is an important source of economic activity in Japan.

The Japanese estimate that the impact on GNP over the next year of this package will be an increase of 1.3 percent. Estimated growth in Japan for 1985 is 4.7 percent. They estimate that 4 percent of that is domestic demand led.

If you believe the Japanese figure of 1.3 percent being added onto present economic activity, that is a fairly significant move. We don't necessarily share their exact calculation, but we do think the measures they have announced are going to produce a higher level of economic activity and that would suggest that fundamentals in Japan are going to continue to move in the direction they're moving.

My view is that the exchange markets over time—and after all, a month has passed since we were at the Plaza Hotel—over time, the market will seek new exchange rate relationships that reflect these changing fundamentals.

And in the case of the United States, as they see what happens with the deficit reduction package that was passed this summer and as they follow the progress of Gramm-Rudman, they will make judgments about our progress too, and they're likely to be that we are improving our fundamentals on the deficit reduction side.

Senator RIEGLE. We're caught in a time bind today because we have matters on the floor in connection with legislation that brings up a variety of different amendments.

I wish we had more time to engage in a longer discussion. I have a series of questions that I'm going to have you respond to for the record.

Let me just say that my concern to you is this. I think there are a whole host of things we need to do now with a new sense of urgency. I mean a much more comprehensive national strategy that takes and deals with why these currency differentials and these enormous foreign borrowings have occurred the way they have and are continuing to occur. I think until we put together first an honest explanation of the nature of the problem and therefore a package of efforts designed to do something about it, including driving up productivity rates at a much faster pace than we are presently doing here in our own country, that most of what we're

doing here is destined to wash away before long. That's my view. You may not agree with it. I'm not asking you to agree with it.

But I know just speaking for myself, I would feel much better if I saw some kind of A to Z strategy being put together here that I thought was going to get the job done. I don't see it and I don't think the markets see it—not just the Tokyo markets, I don't think the markets here see it. And they're not going to see it until it exists and it's not going to exist until policy people like yourself fight hard to get it.

I'll yield at that point, Mr. Chairman, so we can get to the next panel.

Senator HEINZ. Thank you. I'm going to submit, Mr. Mulford, some questions for you as well. I want to thank you for your participation and you obviously are doing a very credible job. As I understood Senator Riegle's comments, he thinks that your attitude on intervention is about right. He's a little skeptical of intervention for its own sake. He would like to see some of the other problems addressed, as I think we all would. We may differ a little bit on what the best way to address them is.

Senator RIEGLE. I think you and I might be able to put a program together, but we've not been asked.

Senator HEINZ. Well, that would be good.

Mr. Mulford, thank you very much. We appreciate your being here.

[The complete prepared statement and response to questions of Senators Heinz, Proxmire, and Riegle follow:]

STATEMENT OF THE HONORABLE DAVID C. MULFORD
ASSISTANT SECRETARY OF THE TREASURY
FOR INTERNATIONAL AFFAIRS
BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
SUBCOMMITTEE ON INTERNATIONAL FINANCE
AND MONETARY POLICY

Washington, D.C.
October 23, 1985

The Group of Five Meeting and Announcement:
Context and Perspective

Mr. Chairman, Members of the Committee:

I welcome this opportunity to present the Treasury Department's views on the important issues your Subcommittee has under consideration. I appreciate your interest in the September 22 announcement of the G-5 Finance Ministers and Central Bank Governors, and how it will work to reduce economic imbalances, at home and abroad.

The G-5 Announcement is important for several reasons. Most significant is the content of the Announcement itself and its positive implications for future economic policies and performance. It will promote sustained growth and adjustment of external imbalances among our countries. The Announcement also reflects close cooperation and consultations among the major industrial countries. Along with the President's trade policy action plan and our initiative in Seoul on the international debt strategy, it constitutes a key element in our efforts to address current international economic problems and their effects on the U.S. economy.

Three features of the Announcement should be highlighted:

1) it draws attention to changes already occurring in economic fundamentals here and abroad;

2) it affirms the strong prospects for continuing favorable changes in economic fundamentals;

3) it outlines the intentions of the G-5 governments to pursue additional, specific policies to sustain and accelerate the changes in economic performance and policies.

I will focus on these three areas in my testimony.

Evolution of U.S. Current Account Position and the Strong Dollar

Since our trade and current account deficits and the strength of the dollar exchange rate reflect the cumulative impact of a number of forces over the past few years, it is important first to examine how the present situation arose. In 1980, the beginning of the period of sustained dollar appreciation, the U.S. had a merchandise trade deficit of $26 billion. But we had a surplus on our services balance larger than our trade deficit, so the balance on goods and services -- the current account -- was in surplus by $2 billion. Over the period 1980-84 the trade deficit grew, reaching $108 billion on a balance of payments basis last year. At the same time the services surplus fell. As a result the current account shifted from surplus to deficit in 1982, and reached a deficit of $102 billion in 1984. Over this same period, end-1980 to end-1984, the dollar appreciated 41 percent on a trade-weighted basis against the major (G-10) foreign currencies. The dollar peaked against major foreign currencies on February 26, 1985.

Underlying this deterioration of our external accounts -- and the strong dollar -- were two fundamental factors:

-- strong economic performance in the U.S. relative to other major industrial countries; and

-- the LDC debt situation.

A. Disparities in Economic Performance

You are all well aware of the vigorous U.S. expansion and our strong gains in employment since 1982. The performance of our trading partners, however, was relatively weak over this period, coinciding with the period of dollar appreciation, mid-1980 to end-February 1985.

For example, at the end of 1984 industrial production in the United States was 11 percent higher than it was 4 years earlier, despite a year long recession in 1982. In contrast, industrial production in Europe at the end of 1984 was essentially unchanged from its 1980 level. There have also been stark performance differences in a broader measure of output -- real GNP. Our GNP in the fourth quarter of 1984 was 12 percent higher than during the recession's trough in 1982. Real GNP in the other major industrial countries rose only 7 percent over the same period and, in Europe alone, only 4 percent.

This was a reversal of historical trends. During the Sixties, the U.S. economy grew at an average annual rate of 4.2 percent; the rest of the industrial countries grew at a 6.2 percent rate. During the Seventies the growth gap narrowed. We grew 3.1 percent a year on average and our major partners grew 3.8 percent. During 1982-84, our relative growth rates reversed: we grew at an average 5.3 percent, while the other industrial countries grew 2.7 percent. Contrary to patterns in the late 1960s and 1970s when Japanese economic growth was appreciably stronger than that of the U.S., in 1983 and 1984 the U.S. economy expanded more rapidly than the Japanese economy.

U.S. inflation performance also improved markedly, relative to Europe, between 1980 and 1984. The U.S. inflation rate fell from 13.5 percent in 1980 to 4.3 percent in 1984, an improvement of over 9 percentage points. Inflation in the four major European countries fell from an average of 12.8 percent in 1980 to 5.9 percent in 1984, an improvement of 6.9 percentage points.

Why has U.S. performance been so strong relative to Europe in particular? The answer is found in the economic policies pursued by the Administration and Congress over the past five years. Anti-inflation efforts, deregulation, tax reductions, and a shift both in attitude and behavior towards free markets stimulated investment and increased rates of return to entrepreneurship. The dynamic and flexible environment produced by these policies is reflected in the creation of over 8-1/2 million jobs during the current expansion.

By contrast, European growth and job creation have been hampered by policies that have limited their economies' ability to adapt to changing economic circumstances. For example, an array of hiring and firing regulations and generous unemployment benefits have raised the cost to firms of taking on new workers and reduced the desire of workers to seek new jobs. Europe lost over half a million jobs during 1982-84 -- at a time of positive growth.

These differences in economic performance had a strong impact on the trade balance and the dollar over the past five years:

-- Stronger U.S. growth relative to our major trading partners resulted in strong U.S. import growth and weak export growth. As a rule of thumb, each one percent of U.S. GNP growth raises our imports by $9.5 billion; each one percent of growth by the other major countries increases U.S. exports by $4.5 billion.

-- With respect to Japan, a more important factor than the growth differential in our weak export growth has been the closed nature of Japan's tradeable goods sector. Solid expansion of Japanese GNP since 1980 has not produced much U.S. export growth.

-- U.S. investors looked at our strong economic performance, our stable political environment and our high after-tax real rates of return on investment, in both absolute terms and relative to our trading partner countries, and decided to keep their money at home. Foreign investors found dollar assets attractive for similar reasons, and increased their investments in the U.S. Strong net capital inflows to the United States contributed to the appreciation of the dollar.

B. LDC Debt Situation

I mentioned earlier that the LDC debt situation was also a major element in our trade deficit and the strong dollar. In 1980, the non-OPEC LDCs accounted for nearly 30 percent of our exports. But as their external and domestic economic conditions deteriorated with the emergence of the international debt problem, their economic growth fell sharply. As you know, many of our Latin American trading partners have experienced particularly serious debt problems, with one of the results being that our exports to Latin America fell $16 billion between 1981 and 1983. Last year, as these debtor countries began to see the initial benefits of adjustment efforts, our exports to Latin America rose about $4 billion, recouping some of the lost exports. But our exports to Latin America still were $12 billion below the 1981 level, and our exports to all non-OPEC LDCs in 1984 were about $7 billion below the 1981 level.

Abstracting for a moment from the current situation gives us an idea of the impact that large growth differentials and the debt situation have had on our trade balance. If U.S. exports to LDCs had grown at a historically reasonable 8 percent per annum in the 1982-84 period instead of falling -- due to the debt situation -- then total U.S. exports would have been $25 billion higher than they were last year. By a similar calculation, our exports to Europe would also have been some $25 billion higher if their economies had experienced modest growth. In other words, if Europe had expanded more rapidly and the LDCs had not experienced a serious debt crisis, we would be discussing today a trade deficit of about $50 billion rather than the more than $100 billion recorded in 1984.

The debt situation also contributed to the stronger dollar, through its impact on the U.S. capital account. Between 1982 and 1984, net U.S. commercial bank lending swung from an outflow of $45 billion to an inflow of $23 billion. This large swing reflected in part the preference of U.S. banks to lend domestically rather than to LDCs after the debt problem emerged late in 1982. It is also likely that the sizeable difference between recorded U.S. net capital inflows and our current account deficit primarily reflects unrecorded capital flows from the developing world to the U.S. -- the safe haven factor. Poor domestic economic performance and a general lack of confidence in economic policies encouraged domestic investors in LDCs to send their money abroad.

C. The Strong Dollar

Up to this point, I have treated the trade deficit and the strong dollar as separate phenomena, both reflecting the common underlying factors of disparities in performance and the LDC debt situation. However, I recognize that the strong dollar has directly contributed to the deterioration in the trade balance by making our goods less price competitive abroad and foreign goods more price competitive here. We estimate that the appreciation of the dollar may have accounted for one third to one half of our trade balance deterioration.

I know many will argue that the dollar has been strong because of high U.S. interest rates. Undoubtedly, interest rates have been a factor underlying dollar strength over the past four years. But unlike the fundamental factors we have noted, the facts do not demonstrate a strong and consistent relationship between the strength of the dollar and interest rate developments over the period of dollar strength as a whole.

Changes in Fundamentals

Over the past several months the economic situation of the main industrial countries and some LDCs has changed significantly. But it has taken quite some time for these changes to become visible, and perhaps even longer for the accumulation of positive signs to become convincing as an indicator of durable changes.

The change has been to more moderate and therefore more sustainable U.S. growth; to higher growth abroad, including many developing countries; to a pattern of foreign growth more based on domestic sources of demand; and to lower inflation. Thus there has been economic convergence of the best sort: towards solid, sustainable real growth and low inflation. Let me be more specific about these points.

Last year the spread between the highest and lowest growth rates among the Five was 5.2 percentage points, with the United States far above the others. This year we expect the spread to narrow to 3-1/2 points, with the United States in the middle. Next year a further narrowing to a 2-1/2 point spread is projected. There is also a convergence in growth rates emerging between the industrial world and non-OPEC developing countries. After years of slow growth, LDCs grew over 4 percent last year, the best performance since 1980. We expect 3-1/2 to 4 percent aggregate growth in these countries for both this year and next.

Stronger growth in Europe is particularly noteworthy. After earlier export-led growth, investment demand has been picking up. In Germany, for example, we expect growth in real domestic demand to be double last year's rate. Real GNP grew at an annual rate in excess of 5-1/2 percent in the second quarter, according to figures released last month. And the tax reduction which will take effect starting in January 1986 should provide a strong boost to consumption spending. We are currently observing forecasters

reacting to these signs of strength by raising their growth projections. The UK is set to chalk up a strong rise in GDP this year, with private investment a major source of stimulus. GDP was up 4-1/2 percent (annual rate) in the second quarter.

In addition to a more positive picture for foreign growth which has recently emerged, inflation rates have been converging around a downward trend. The G-5 weighted average this year should be the lowest in nearly 20 years. The point spread is declining too. With the big improvement in France, the spread fell from 7-1/2 points in 1983 to 5 last year. It should be close to 4 points for 1985 and even less next year. This decline in inflation -- in other industrial countries too -- is gradually creating more optimism about prospects for continued lower inflation, particularly in countries earlier experiencing poor price performance.

Some of these changes were hard to see during the first half of this year. Aggregate real GNP in the seven Summit countries grew at a seasonally adjusted annual rate of only 0.3 percent in the first quarter, and included a sharp downturn in Germany and practically no growth in Japan. In contrast, the second quarter aggregate growth rate was nearly 4 percent. And of course the data showing higher GNP and industrial production were available only with considerable time lags.

Other elements of the picture were also changing. U.S. interest rates had been coming down sharply since the summer of 1984. U.S. monetary growth had accelerated. An agreement on a budget deficit reduction package was reached in August. The dollar had begun to decline substantially from its late winter peaks, and markets began to recognize the possibility of dollar decline. In market terms, one could say that the rising dollar was no longer a one-way street. Indeed, by July the foreign exchange markets had begun to recognize some of the early signs of a changing economic situation, which contributed to the rise of major foreign currencies against the dollar prior to the G-5 meeting. Between the February 26 dollar peak and September 20 the dollar fell 18 percent against the German mark and French franc, 9 percent against the yen and 24 percent against sterling.

At the G-5 meeting on September 22, Finance Ministers and Central Bank Governors recognized the improvement in convergence of favorable economic performance and policies, but noted that exchange rates were not fully reflective of changing economic fundamentals. Part of the reason for their Announcement was to draw attention to their analysis of the visible strengthening in foreign economic performance and prospects. In addition, it was agreed that policies here and abroad were the main force working to sustain this brighter picture. Without repeating all of the specific policy changes that took place before the September 22 Announcement, I would like to highlight a few: general reduction in interest rates, the two-stage German tax cuts, the liberalizing steps in French capital markets, UK proposals to reform wages councils so as to encourage employment, and Japanese plans to

strengthen domestic demand and new efforts to open markets for imports.

G-5 Policy Intentions

More importantly, each country agreed to make specific additional commitments to future policies which will strengthen the commitments to strong, noninflationary growth. The breadth, scope, and importance of these intentions can be demonstrated by a few examples:

-- The United States agreed to continue efforts to reduce government expenditures and implement fully the deficit reductions package for FY86. In this regard we support the major move by Congress to move toward a balanced budget by cutting spending. We also agreed to conduct monetary policy conducive to sustained growth and price stability;

-- The U.K. made a commitment to reduce the burden of taxation, in order to improve incentives and to increase the efficient use of resources in the economy.

-- Germany stated that the tax cuts due to take effect in 1986 and 1988 form part of the ongoing process of tax reform and reduction which the Federal Government will continue in a medium-term framework.

-- France agreed that it would take further steps towards liberalization and modernization of financial markets.

-- Japan agreed to efforts to stimulate domestic demand which will focus on increasing private consumption and investment through measures to enlarge consumer and mortgage credit markets. They indicated in addition that, within the framework of reducing the central government deficit and providing a pro-growth environment for the private sector, local governments may be favorably allowed to make additional investments. We welcome the package to promote domestic demand-led growth announced by the Japanese Government on October 15. This package, which provides greater access to consumer credit and promotes stronger private investment and expansion of public works projects, constitutes an important step in following-up on commitments made in the G-5 Announcement.

It was recognized at the G-5 meeting that these measures will promote better economic performance and greater convergence, which would contribute to a strengthening of non-dollar currencies and in turn to adjustment of the large trade imbalances among the major countries.

The G-5 Announcement of September 22 had an immediate, significant impact on exchange markets which continues to be positive, and reflects the importance of the commitments made. The dollar has fallen an additional 7 percent against the DM and French franc, about 9 percent against the yen and 4 percent against sterling.

The effect overall of this strengthening of foreign currencies from late February to date has been to reverse much of the long dollar run-up. About 55 percent of the dollar's rise against the DM between the end of 1980 and last February's peak has now been reversed, as has over 40 percent of the rise against the franc and sterling, and over 75 percent of the rise against the yen.

The decline of the dollar -- which is the counterpart of a strengthening of other currencies -- since the end of February has taken place under generally orderly market conditions, supporting our view that the exchange market was basically reacting to better prospects abroad rather than to any concerns about U.S. economic performance.

As a result of the confidentiality we were able to maintain during the three-month period of consultations leading to the September 22 meeting, the G-5 Announcement surprised the market and had a strong psychological effect. In accordance with our long-stated willingness to undertake coordinated intervention in instances where it is agreed that such intervention would be helpful or necessary, such intervention has been undertaken. While I cannot comment on the nature, timing, or amounts, I can assure you that there has been a high degree of cooperation and coordination among the various monetary authorities. We have developed clear, detailed procedures on how intervention operations might be conducted. We have not sought to establish target zones or target exchange rates. We are determined, however, to demonstrate our seriousness of intent over a prolonged period -- through policy actions as well as exchange market operations -- to help accelerate the convergence of economic performance among the major countries and further strengthen non-dollar currencies.

The Announcement also represents a major step forward in the process of multilateral surveillance and cooperation among the major industrial countries. It serves as a clear example of the willingness of governments to recognize the external effects of their policies and the need for active, ongoing consultations. The cooperative spirit reflects our deep-seated concerns about growing protectionist threats. The Announcement is a positive method of dealing with trade imbalances -- it focuses on economic fundamentals and policies. The implementation of protectionist policies would be a self-defeating, negative approach to resolving trade imbalances. Protectionism must be rejected.

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Mr. Chairman, you have asked me to focus on the G-5 Announcement and its implication for the dollar and the trade deficit. However, I should note that the Announcement, while significant on its own merits, in its own right constitutes only a part of our overall approach to the range of issues affecting trade and the dollar.

Indeed, the Announcement itself has wider implications, especially for the LDC debt situation.

-- As part of the convergence process interest rates are down across-the-board. OECD interest rates are on average only half as high as four years ago. Dollar LIBOR interest rates, of key importance for variable interest rate LDC bank borrowings, have come down to levels below the 1978 average, prior to the late 1970s inflation and sharp run-up of LDC bank debt.

-- The Announcement emphasizes the crucial importance of resisting protectionism and keeping markets open, explicitly recognizing the implications for LDC adjustment efforts.

-- Sustained growth in industrial countries complements market openness in providing needed export demand for LDCs seeking to service debt and restore creditworthiness.

As Secretary Baker recently said at the annual meetings of the IMF and World Bank in Seoul,

"I am convinced that if each of the major industrial nations fulfills its policy intentions and maintains or improves access to its markets, we will have taken a major step toward more balanced and sustainable growth, while providing a solid framework for improving the debt situation in the developing world."

Conclusion

We believe the G-5 Announcement constitutes a broad-gauge approach to the fundamental determinants of U.S. trading performance and the value of the dollar. It addresses each of the factors I cited in my analysis of the causes of dollar strength and the trade deficit:

-- weak domestic demand in other industrial countries;

-- the LDC debt situation;

-- the slowness of currencies to reflect convergence.

It also stresses the importance of strengthening the open, liberal international economic system which is basic to our continued prosperity. This is a positive response to our problems, in contrast to the negative response of protectionism.

We recognize that the G-5 measures require time to implement and take full effect. However, the progress already visible on convergence of economic growth and inflation and developments in exchange markets gives us a good down payment.

The substantial dollar depreciation since last spring and closer convergence of U.S. and foreign growth rates makes our trade deficit forecast for 1986 $30 billion lower for the year as a whole than we would be forecasting if the exchange rate had remained at its February level and U.S. and foreign growth rates had held to the wider-gap scenario expected in March. By the fourth quarter of next year, the improvement on the trade account will be running at a $40-50 billion annual rate.

When fully effective, our various initiatives should provide even greater results.

Mr. Chairman, your letter of invitation asked what can we do to ensure maximum benefit from our efforts in the shortest time. I would like to suggest two areas where we need Congress' active participation:

-- fulfilling the U.S. policy intentions which were an integral part of the G-5 Announcement.

-- authorizing and appropriating quickly the $300 million war chest to combat predatory tied aid credits.

In particular, this means:

-- implementing the budget deficit reduction package;

-- enacting meaningful tax reform; and

-- resisting protectionism.

It is through these measures that you can make a direct, substantial contribution. I will be pleased to respond to your questions.

September 22, 1985

Announcement of the Ministers of Finance and Central Bank Governors of France, Germany, Japan, the United Kingdom, and the United States

1. Ministers of Finance and Central Bank Governors of France, the Federal Republic of Germany, Japan, the United Kingdom, and the United States met today, September 22, 1985, in the context of their agreement to conduct mutual surveillance and as part of their preparations for wider international discussions at the forthcoming meetings in Seoul, Korea. They reviewed economic developments and policies in each of their countries and assessed their implications for economic prospects, external balances, and exchange rates.

2. At the Bonn Economic Summit in May 1985 the Heads of State or Government of seven major industrial countries and the President of the Commission of the European Communities issued an Economic Declaration Towards Sustained Growth and Higher Employment. In that Declaration the participants agreed that:

> The best contribution we can make to a lasting new prosperity is which all nations can share is unremittingly to pursue, individually in our own countries and cooperatively together, policies conducive to sustained growth and higher employment.

3. The Ministers and Governors were of the view that significant progress has been made in their efforts to promote a convergence of favorable economic performance among their countries on a path of steady noninflationary growth. Furthermore, they concluded that their countries are restoring the vitality and responsiveness of their economies. As a result of these developments, they are confident that a firm basis has been established for a sustained, more balanced expansion among their countries. This sustained growth will benefit other industrial countries and will help ensure expanding export markets for developing countries, thereby contributing importantly to the resolution of problems of heavily indebted developing countries.

4. They believe that this convergence of favorable economic performance has been influenced increasingly by policy initiatives undertaken by their countries. Moreover, each of their countries is committed to the implementation of further policy measures which will reinforce favorable convergence and strengthen the sustainability of the current expansion.

5. Ministers and Governors were of the view that recent shifts in fundamental economic conditions among their countries, together with policy commitments for the future, have not been reflected fully in exchange markets.

Recent Economic Developments and Policy Changes

6. Ministers and Governors expect that real growth in aggregate for their countries will be about 3 percent this year, compared to negative growth of -0.7 percent in 1982. Although this figure is down slightly from 1984, growth will be more balanced than at any time in the last four years. After the particularly rapid U.S. growth of 1983-84, there is now increased evidence of internal growth in the other countries. In particular, private investment has picked up strength. The current expansion is occurring in a context of fiscal consolidation; it is not dependent on shortlived fiscal stimulus. As a result of the changes in the components of growth, real growth in their countries can be expected to remain strong as U.S. growth moderates.

7. The current sustained expansion is occurring within a framework of declining inflation, a phenomenon that is unprecedented in the past three decades. Inflation rates are at their lowest in nearly 20 years, and they show no signs of reviving.

8. There has been a significant fall in interest rates in recent years. Apart from welcome domestic effects, this has been particularly helpful in easing the burden of debt repayments for developing countries.

9. This successful performance is the direct result of the importance given to macroeconomic policies which have reduced inflation and inflationary expectations, to continued vigilance over government spending, to greater emphasis on market forces and competition, and to prudent monetary policies.

10. These positive economic developments notwithstanding, there are large imbalances in external positions which pose potential problems, and which reflect a wide range of factors. Among these are: the deterioration in its external position which the U.S. experienced from its period of very rapid relative growth; the particularly large impact on the U.S. current account of the economic difficulties and the adjustment efforts of some major developing countries; the difficulty of trade access in some markets; and the appreciation of the U.S. dollar. The interaction of these factors -- relative growth rates, the debt problems of developing countries, and exchange rate developments -- has contributed to large, potentially destabilizing external imbalances among major industrial countries. In particular, the United States has a large and growing current account deficit, and Japan, and to a lesser extent Germany, large and growing current account surpluses.

11. The U.S. current account deficit, together with other factors, is now contributing to protectionist pressures which, if not resisted, could lead to mutually destructive retaliation with serious damage to the world economy: world trade would shrink, real growth rates could even turn negative, unemployment would rise still higher, and debt-burdened developing countries would be unable to secure the export earnings they vitally need.

Policy Intentions

12. The Finance Ministers and Governors affirmed that each of their countries remains firmly committed to its international responsibilities and obligations as leading industrial nations. They also share special responsibilities to ensure the mutual consistency of their individual policies. The Ministers agreed that establishing more widely strong, noninflationary domestic growth and open markets will be a key factor in ensuring that the current expansion continues in a more balanced fashion, and they committed themselves to policies toward that end. In countries where the budget deficit is too high, further measures to reduce the deficit substantially are urgently required.

13. Ministers and Governors agreed that it was essential that protectionist pressures be resisted.

14. Ministers recognized the importance of providing access to their markets for LDC exports as those countries continue their essential adjustment efforts, and saw this as an important additional reason to avoid protectionist policies. They welcomed the GATT preparatory meeting scheduled for late September and expressed their hope that it will reach a broad consensus on subject matter and modalities for a new GATT round.

15. In this context, they recalled and reaffirmed the statement in the Bonn Economic Declaration on the debt situation.

> Sustained growth in world trade, lower interest rates, open markets and continued financing in amounts and on terms appropriate to each individual case are essential to enable developing countries to achieve sound growth and overcome their economic and financial difficulties.

16. The Ministers agreed that they would monitor progress in achieving a sustained noninflationary expansion and intensify their individual and cooperative efforts to accomplish this objective. To that end, they affirmed the statements of policy intentions by each of their countries, which are attached.

Conclusions

17. The Ministers of Finance and Central Bank Governors agreed that recent economic developments and policy changes, when combined with the specific policy intentions described in the attached statements, provide a sound basis for continued and a more balanced expansion with low inflation. They agreed on the importance of these improvements for redressing the large and growing external imbalances that have developed. In that connection, they noted that further market-opening measures will be important to resisting protectionism.

18. The Ministers and Governors agreed that exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case. They believe that agreed policy actions must be implemented and reinforced to improve the fundamentals further, and that in view of the present and prospective changes in fundamentals, some further appreciation of the main non-dollar currencies against the dollar is desirable. They stand ready to cooperate more closely to encourage this when to do so would be helpful.

The French Government intends to pursue its policy aimed at reducing inflation, moderating income growth, and achieving continued improvements in external accounts. It will further intensify its efforts to speed up structural adjustment and modernization and thus lay the basis for job creating growth.

Therefore, it is determined:

1. To pursue vigorously disinflation.

2. To secure the attainment of monetary aggregates growth targets, consistent with decelerating inflation.

3. To curb public expenditures progressively so as to lower the tax burden while reducing the government borrowing requirement.

4. To foster the investment recovery allowed for by the improved financial situation in the business sector.

5. To take further steps towards liberalization and modernization of financial markets, to increase competition in the financial sector so as to reduce financial intermediation costs and give a greater role to interest rates in monetary control.

6. To foster job creation through the implementation of an innovative and active policy in the field of education and training and by promoting constructive discussions between social partners on work organization.

7. To resist protectionism.

The Government of the Federal Republic of Germany, noting that the German economy is already embarked on a course of steady economic recovery based increasingly on internally generated growth, will continue to implement policies to sustain and extend the progress achieved in strengthening the underlying conditions for continuing, vigorous, job-creating growth in the context of stable prices and low interest rates.

In particular, the Government of the Federal Republic of Germany will implement policies with the following explicit intentions.

1. The priority objective of fiscal policy is to encourage private initiative and productive investments and maintain price stability.

2. Toward this end, the Federal Government will continue to reduce progressively the share of the public sector in the economy through maintaining firm expenditure control. The tax cuts due to take effect in 1986 and 1988 form part of the ongoing process of tax reform and reduction which the Federal Government will continue in a medium-term framework.

3. The Federal Government will continue to remove rigidities inhibiting the efficient functioning of markets. It will keep under review policies, regulations, and practices affecting labor markets in order to enhance the positive impact of economic growth on employment. The Federal Government and the Deutsche Bundesbank will provide the framework for the continuing evolution of deep, efficient money and capital markets.

4. The fiscal policy of the Federal Government and the monetary policy of the Deutsche Bundesbank will continue to ensure a stable environment conducive to the expansion of domestic demand on a durable basis.

5. The Federal Government will continue to resist protectionism.

The Government of Japan, noting that the Japanese economy is in an autonomous expansion phase mainly supported by domestic private demand increase, will continue to institute policies intended to ensure sustainable noninflationary growth; provide full access to domestic markets for foreign goods; and internationalize the yen and liberalize domestic capital markets.

In particular, the Government of Japan will implement policies with the following explicit intentions.

1. Resistance of protectionism and steady implementation of the Action Program announced on July 30 for the further opening up of Japan's domestic market to foreign goods and services.

2. Full utilization of private sector vitality through the implementation of vigorous deregulation measures.

3. Flexible management of monetary policy with due attention to the yen rate.

4. Intensified implemention of financial market liberalization and internationalization of the yen, so that the yen fully reflects the underlying strength of the Japanese economy.

5. Fiscal policy will continue to focus on the twin goals of reducing the central government deficit and providing a pro-growth environment for the private sector. Within that framework, local governments may be favorably allowed to make additional investments in this FY 1985, taking into account the individual circumstances of the region.

6. Efforts to stimulate domestic demand will focus on increasing private consumption and investment through measures to enlarge consumer and mortgage credit markets.

The United Kingdom Government, noting that the British economy has been experiencing steady growth of output and domestic demand over the past four years, will continue to pursue policies designed to reduce inflation; to promote sustained growth of output and employment; to reduce the size of the public sector; to encourage a more competitive, innovative, market orientated private sector; to reduce regulation and increase incentives throughout the economy; and to maintain open trading and capital markets free of foreign exchange controls.

In particular, the United Kingdom Government intends:

1. To operate monetary policy to achieve further progress towards price stability and to provide a financial environment for growing output and employment; and to buttress monetary policy with a prudent fiscal policy.

2. To continue to reduce public expenditure as a share of GDP and to transfer further substantial parts of public sector industry to private ownership.

3. To reduce the burden of taxation in order to improve incentives and to increase the efficient use of resources in the economy.

4. To take additional measures to improve the effective working of the labour market, including the reform of Wages Councils and improvements in youth training; and implement proposals to liberalise and strengthen competition within financial markets.

5. To resist protectionism.

The United States Government is firmly committed to policies designed to: ensure steady noninflationary growth; maximize the role of markets and private sector participation in the economy; reduce the size and role of the government sector; and maintain open markets.

In order to achieve these objectives, the United States Government will:

1. Continue efforts to reduce government expenditures as a share of GNP in order to reduce the fiscal deficit and to free up resources for the private sector.

2. Implement fully the deficit reduction package for fiscal year 1986. This package passed by Congress and approved by the President will not only reduce by over 1 percent of GNP the budget deficit for FY 1986, but lay the basis for further significant reductions in the deficit in subsequent years.

3. Implement revenue-neutral tax reform which will encourage savings, create new work incentives, and increase the efficiency of the economy, thereby fostering noninflationary growth.

4. Conduct monetary policy to provide a financial environment conducive to sustainable growth and continued progress toward price stability.

5. Resist protectionist measures.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HEINZ
FROM DAVID C. MULFORD, TREASURY DEPARTMENT

Question #1

The United States initiated the process that consisted of increased meetings of the G-5 and which led to the G-5 communique this September. Does this indicate that the Administration intends to use the G-5 in a regular manner to coordinate macroeconomic policies and exchange rate intervention? Is the G-5 an appropriate tool for this, or is a new mechanism called for in order to achieve meaningful coordination of macroeconomic policies?

Answer

The September 22 meeting is part of a continuing process to achieve sustained growth in the world economy and a smoothly functioning international monetary system. Over the years, the G-5 has proven to be an effective forum for informal consultations on current economic and financial issues by the key industrial countries. Discussions on these issues also take place in other fora, including the Economic Summits, the IMF, the OECD, and the G-10.

What is needed at this stage is not new mechanisms but rather the political will among sovereign nations to take adequate account of the international implications of domestic policies in national decision-making. The G-5 Announcement represents an important step in achieving meaningful international cooperation and coordination of economic policies but it is only the beginning of what must be an ongoing process.

Question #2

Trade flows are dwarfed in their significance and their effect on exchange rates by international capital flows. I believe that Treasury's own estimates are that capital flows are as much as ten times the value of trade flows. This seems to have eliminated the ability of trade imbalances to correct themselves by their effect on exchange rates. What can take the place of this mechanism, or must we be willing to live with severe trade imbalances if they are dictated by capital flows? If not, does this indicate an increasingly active role for Government?

Answer

The increased role played by international capital flows is a reflection of the increased openness of economies to both goods and capital from abroad. The open trade and payments system which is the legacy of Bretton Woods and the liberalization which has occurred over the past two decades -- particularly in capital markets -- have been central to our economic success.

It's true that rapid shifts in capital flows can lead to exchange rate volatility, with at times a major impact on trade. But the solution is not capital controls, which would risk introducing even greater distortions and inefficiency into the system in general, and in domestic economies in particular. Rather, we need to improve the stability of the overall international monetary system, through stronger international surveillance and greater convergence of economic policies and performance.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR PROXMIRE
FROM DAVID C. MULFORD, TREASURY DEPARTMENT

Question #1

(a) Do you agree that "the floating exchange rate system as it now operates will make survival of the GATT concept impossible?"

(b) Do we need to reform the international monetary system before proceeding to another round of GATT negotiations?

Answer:

(a) No. GATT is based on the concept of substantially reducing tariffs and other barriers to trade through reciprocal and mutually beneficial trade negotiations. That objective can be pursued under any exchange rate system, with beneficial effects for all participants in terms of improved general welfare and a more efficient use of resources.

These benefits are not diminished by exchange rate movements. Economies are still better off than they would have been in the absence of trade negotiations. Relative advantages gained through trade negotiations by individual sectors of an economy also are not affected by exchange rate changes, which affect all goods equally. A flexible exchange rate system, in fact, can help in the adjustment process by transmitting more accurately market signals.

There is no more reason to look at the impact of exchange rate movements on trade concessions than to examine the impact of other variables, such as economic growth or inflation. Indeed, by reducing distortions within and among economies, trade negotiations can help to improve the operation of a flexible exchange rate system.

(b) No. Discussions on improving the international monetary system are already well underway. The Group of Ten industrial nations and the Group of 24 developing nations have both prepared reports on ways to improve the system which are being reviewed with the IMF and will be discussed in detail at the IMF Interim Committee meeting in April of 1986.

Progress in the monetary area should not be held hostage to progress in the trade area, or vice versa. Each should proceed on its own track, recognizing that each system will benefit from improvements in the other.

Question #2

In 1984 when Dr. Feldstein, then Chairman of the President's Council of Economic Advisors testified before this Committee on misaligned exchange rates, he said "In the future the United States will have to give up some of each future year's GNP to our creditors abroad to pay for today's excess of imports over exports." Do you agree that today's trade deficit will result in a lower standard of living for tomorrow's Americans than would otherwise be the case? If so can you explain why. If not, why not?

Answer

In the future, the U.S. will have to transfer net real resources abroad to service its international indebtedness, which is the result of our trade deficit. This means that, in the future, our trade balance will have to show a larger surplus than it would have otherwise. But this does not mean that the U.S. standard of living will be reduced. The driving force behind the strong dollar and trade deficit has been a very large net inflow of capital, attracted by high real rates of return and a favorable investment climate. Higher domestic investment, financed by this capital inflow, creates the additional productive capacity to accomplish the subsequent real resource transfer without any reduction in economic well-being.

Question #3

In your prepared statement you argue that a good portion of our trade deficit is caused by the fact that European economies have not grown much in the last four years and thus have not been a good market for American exports.

A recent study by the Council for International Business agrees that Europe has not been a good market but contends this is a result of the Administration's budget deficits which have driven up American interest rates. This study states that as a result "foreign countries must raise interest rates to keep capital at home for investment, and this reduces economic growth rates as well as the demand for U.S. made goods." Do you think that argument has any validity? Why or why not?

Answer

The CIB argument relies on a link between U.S. budget deficits and interest rates. Research by Treasury staff, as well as within the academic community, has shown no consistent, predictable relationship between the deficit and interest rates. Indeed, as estimates of the budget deficit climbed over the past several years, interest rates fell.

The data show that the rise in net capital inflow is largely due to a reduction in net lending abroad by U.S. banks, not to a surge in foreign lending to the United States. While there has also been an increase in inflows of capital from abroad, this has largely financed private sector borrowing, and has come in response to an improved investment climate in the United States, resulting from strong real growth, low inflation and an incentive-oriented tax program.

Question #4

In a follow up to my question about the slow growth of the Euopean economies I also note the contention in your prepared statement that a good portion of our trade deficit is due to the LDC debt crises and the consequent inability of those countries to buy American products. I understand that much of that LDC debt is at variable interest rates. Isn't it a fact that the Administration's budget deficits, which keep real interest rates at an all time high, are also having a very adverse impact on the economies of the LDC's and their ability to buy American products? Please comment.

Answer

As I have noted elsewhere, Treasury staff research -- as well as academic studies -- show no consistent, predictable relationship between the budget deficit and interest rates. Indeed, as estimates of the budget deficit rose over the past several years, interest rates fell.

It is true that a substantial amount of LDC debt is at variable rates -- often linked with LIBOR. As U.S interest rates have come down so has LIBOR -- by nearly 1/3%, from over 12-1/2% to under 8-1/2%, between July 1984 and August 1985. We estimate that each 1% decline in LIBOR saves the non-OPEC LDCs $3.3 billion a year in debt service payments.

Question #5

You have not really said much about the details of the Administration's plans to intervene in currency markets. Will you give us some details on the contemplated size of the intervention? Will the Administration rely on money in the Economic Stabilization Fund? Will any intervention be sterilized or unsterilized?

Answer

As I indicated in my testimony, I cannot comment on the nature, timing, or amounts of intervention. We will continue to undertake coordinated intervention in instances where it is agreed that such intervention would be helpful or necessary, but it is not possible to estimate likely future operations.

U.S. intervention is financed by the Federal Reserve System and the Exchange Stabilization Fund of the Treasury.

U.S. exchange market intervention is routinely sterilized by the Federal Reserve. The monetary effects of intervention are taken into account, along with other factors that affect reserves, in the implementation of the Federal Reserve's monetary policy.

SENATOR PROXMIRE

Question #6

Dr. Martin Feldstein, formerly Chairman of the Council of Economic Advisors under President Reagan, recently wrote an article commenting on the Administration's decision to intervene in currency markets in an attempt to lower the value of the dollar. He said "Now that the Administration has finally admitted our trade deficit is tied to the over-valued dollar - isn't it time to admit that it's the budget deficit that is keeping the dollar so high?" Why does the Administration avoid making that connection? Please comment.

Answer

It is true that many U.S. industries that produce traded goods have experienced a decrease in demand for their products as the value of the dollar rose. However, the conclusion that these developments are to be attributed to the Federal budget deficit is faulty on several counts. Such a conclusion assumes a series of linkages from the budget deficit to interest rates and, finally, to the dollar. Research by staff at Treasury, as well as within the academic community, has shown no consistent, predictable relationship between the deficit and interest rates. Indeed, as estimates of the budget deficit climbed over the past several years, interest rates fell.

The link between interest rates and the dollar is also weak. Undoubtedly, interest rates have been a factor underlying dollar strength over the past four years. But the facts do not demonstrate a strong and consistent relationship between the strength of the dollar and interest rates over the period of dollar strength as a whole.

While I feel Dr. Feldstein's emphasis on deficits as the primary cause of the strong dollar is misplaced, we agree that it is important to reduce the deficit. The way to do so is by cutting spending. Federal expenditures, whether paid for by taxing or borrowing, use resources that could more productively be used in the private sector.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR RIEGLE
FROM DAVID C. MULFORD, TREASURY DEPARTMENT

Question #1

What leads you to believe that small and medium-size banks are going to make new loans in the amount that you are asking them to make to the debtor countries and what will be the effect on the Administration's plan for dealing with the lesser-developed country debt problems if the non-money center banks refuse to make additional new loans?

Why is it in the interests of the smaller and medium-size banks to continue to lend to the LDCs?

Answer

Smaller banks should participate in the Program for Sustained Growth for the same reason as larger banks -- it is in their own self-interest to do so. It is in the interest of all banks to have healthy loan customers and a strong international economy. I hope that all banks with exposure to the countries concerned will participate. If some smaller banks decide that direct participation is not in their interest, then the Program could only succeed if the degree of their non-participation is relatively limited and larger banks are willing to take over their share, or if the smaller banks are prepared to make some kind of alternative contribution. It is up to the banks to work out any such arrangements.

Question #2

My question to you is how seriously do you take the policy of trying to link interest payments to a percentage of export earnings and what would be the effect and impact on United States banks if Peru's linkage was adopted as general policy by other debtor nations?

Answer

I think that unilateral action of this kind would be very disruptive to international debtor/creditor relationships, and that it could seriously jeopardize a debtor country's future access to international credit. I do not detect much support for this approach among debtor countries and believe that Peru may also come to see that such a policy is not in its longer run interest.

The impact on U.S. banks of Peru's policy is manageable from a systemic perspective. Obviously, if such a policy became generalized, there could be systemic implications.

Question #3

What specific actions have been taken by the Administration since the G-5 meeting on September 22, 1985 to live up to the policy intentions outlined in the joint communique?

For instance, the Finance Ministers of the United States, France, Germany, Japan and the United Kingdom each affirmed their commitment that "in countries where the budget deficit is too high, further measures to reduce the deficit substantially are urgently required."

Since September 22, 1985 what plans has the Treasury or the Administration proposed to meet our obligation to reduce the "deficit substantially?"

Answer

The Reagan Administration has endorsed the central theme of the Gramm-Rudman-Hollings proposal to attain a balanced Federal budget by early in the next decade. The Administration has worked and consulted with the Congress in an effort to implement such a plan. At this stage, however, the specifics of the multi-year budgetary cuts are not yet resolved. Pressure for meaningful action has intensified. Americans are seriously concerned about Federal deficit spending and are insistent that the Federal deficit be cut down. The Federal Government continues to absorb too great a share of our national output. Federal spending as a share of GNP has been running in the 24 to 25 percent range, well above the historical average. Federal revenues, on the other hand, have been running close to 19 percent of GNP, or about the historical average, despite the Reagan tax cuts. The deficit has resulted from a surge in spending, and the deficit must be curtailed by cutting spending rather than by increasing tax rates. As the President has noted, if there is a will to do it, the deficit can and will be brought down without raising taxes and without undermining our national security.

Question #4

I am told that one common reaction to the Administration's approach at the IMF Convention in Seoul, South Korea was as follows: "Before you preach your principles to the rest of the world, and before you require additional austerity on the part of the debtor countries and the lesser-developed countries, get your own house in order -- practice a little austerity yourselves and reduce your own deficits." How do you react to that criticism?

Answer

I do not believe that your statement is an accurate reflection of the reaction to the proposals we made in Seoul. Indeed, the response in general has been quite positive.

There is growing recognition and acceptance that the kinds of economic policies which the U.S. advocates -- increased reliance on private markets and a reduced role for government -- is absolutely necessary to achieve increased growth. Other countries look at our economic performance over the past few years -- the longest period of growth in 30 years, big increases in employment, and low inflation -- and are anxious to achieve similar success by adopting the same kinds of supply side policies.

SENATOR HEINZ. Our next set of witnesses is a panel and I'd like to ask Mr. J. Carter Murphy, Mr. John Williamson, and Mr. Stanley Black to please come forward.

Gentlemen, we have an unfortunate time problem this morning that's not of your making; it's of ours; and I'm going to ask that, if you would, to put your prepared statements in the record and I'd like to proceed right to questioning. I feel badly about doing this because some of you have come considerable distances. Mr. Murphy, you've come from Dallas, TX. Mr. Black, you've come from a little closer, Chapel Hill, NC. Mr. Williamson hasn't had to go quite as far afield.

But I would really like to start with a couple of leading questions which I'll ask you each in turn.

STATEMENTS OF J. CARTER MURPHY, PROFESSOR, SOUTHERN METHODIST UNIVERSITY, DALLAS, TX; JOHN WILLIAMSON, INSTITUTE FOR INTERNATONAL ECONOMICS, WASHINGTON, DC; AND STANLEY BLACK, LURCY PROFESSOR OF ECONOMICS, UNIVERSITY OF NORTH CAROLINA, CHAPEL HILL, NC

[The complete prepared statements of J. Carter Murphy, professor, Southern Methodist University, Dallas, TX; John Williamson, Institute for International Economics, Washington, DC; and Stanley Black, Lurcy Professor of Economics, University of North Carolina, Chapel Hill, NC, follow:]

GLOBAL ECONOMIC IMBALANCE AND NEW U.S. INITIATIVES

Statement for the Senate Committee on Banking and Urban Affairs,
October 23, 1985

by

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Introduction

Whether nations operate under a regime of fixed or flexible exchange rates, there are rules about national economic policies to be followed if the system is to work well. Under fixed rates, governments must harmonize their overall demand management policies to suppress international differences in incomes and prices that would wreck the exchange rate pattern. Members of Congress who would go back now to a fixed exchange rate system forget the lessons of the 1960s. Such a regime did not work well then because governments could not harmonize the thrust of their macroeconomic policies, and fixed or targeted exchange rates would not work well now.

Under flexible exchange rates, governments must harmonize the mix of their monetary and fiscal policies if the system is to work well. An unbalanced mix of government deficits and monetary growth among countries affects interest rates and induces international capital flows that distort trade and private investments. Part of the argument for preferring flexible exchange rates over fixed rests on the view that it is easier to achieve agreement among countries concerning the mix of policy instruments than it is to harmonize their overall inflationary or disinflationary objectives.

Unfortunately, the United States contributed heavily to the failure of the pre-1971 fixed exchange rate system by following excessively inflationary policies in the late 1960s and early 1970s. Now it flaunts the rules for good policy under a flexible exchange rate system, contributing to the poor performance of this system.

The foreign exchange value of the dollar has varied widely under shifting economic policies during the past fifteen years. Dynamics initiated by dollar devaluations early in the 1970s were followed by acceleration of U.S. inflation relative to that in other industrialized countries later in the decade and resulted in ten years of chronic depreciation of the dollar's foreign exchange value. Appreciation of the currency began in 1980, after the U.S., in 1979, joined the list of countries where monetary restraint measures were being put in place, and then it was sustained as the 1981 Economic Recovery Tax Act put this country on a recovery that was led by fiscal deficits. Since 1981, some other countries have succeeded in lowering government expenditures, thereby easing a bit in their markets the necessity of monetary restraint. In the U.S., government deficits widened in 1981-82 as a result of the effects of recession on government revenues; the deficit gap was then sustained as a result of expanding government expenditures and the 1981 tax rate reductions. Effective dollar appreciation of about 61 percent between 1980 and February, 1984, contributed to disinflation in the U.S. while effects of the 1981 tax reductions induced, through both supply and demand effects, an economic recovery that was significant even if limited to that sector of the economy that was impacted least by the country's deteriorating international competitive position.

II. Aspects of the Imbalance

I do not wish to be interpreted as believing that the unbalanced U.S. monetary-fiscal mix accounts for all of the economic problems of the world

today. Apart from historic problems, such as income distribution and the need for economic development, a number of troublesome imbalances in the mid-1980s result from lingering effects of the 1970s' inflationary excesses and the measures that ended the cycle of inflationary expectations and actions. Other sources of imbalance are still more fundamental--demographic and cultural. The deficit in the U.S. federal budget, however, is a significant contributing factor, and it is the policy instrument most amenable to change by us.

Before commenting on recent U.S. and G-5 policy initiatives, I would like to mention some manifestations of economic imbalance that deserve clarifying remarks.

High Real Interest Rates. Long-term interest rates adjusted for inflation reached the neighborhood of 9.0 percent in the U.S. in 1984 [1], among the highest such rates in this country's recorded financial history, and higher than comparable rates in Europe and Japan by 3.5 to 4.0 percent. What has brought about such an elevated price for the use of dollars? Major factors have been a persistence of inflationary expectations, fiscal deficits here and abroad, and high real returns to investment, the last partly arising from technological change and tax incentives.

It is unfortunate that inflationary expectations persist so stubbornly in this country, but there is reason for participants in financial markets to be especially apprehensive of inflation in dollar terms. Growth policies instituted in this country in 1981 and 1982 were apparently a response to the belief that U.S. disinflation had reached the point where bad debts were imperilling the domestic and international financial structure and where

[1] International Monetary Fund, World Economic Outlook, April 1985 (Washington, D.C.: International Monetary Fund, 1985), Table 2.7, p. 121.

economic hardships of the unemployed and the indebted were threatening the replacement of policies aimed at long-term recovery with policies of short-term expediency. Monetary policy (in the form of growth in the monetary base) became more accommodative of the fiscal deficit in 1982, and the U.S. economy began its recovery in the final quarter of that year. European members of the OECD have been slower in achieving their disinflation objectives and in turning to demand expanding monetary and fiscal policies. What is clear is that the U.S. has enjoyed a generous share of the world's post-1982 recovery while being shielded from inflation by the continued policies of demand restraint in other countries and by appreciation of the dollar. As recovery spreads in the world economy in coming months, and in the degree that the dollar depreciates, that shield will be removed. Special care must be taken in this country, therefore, that latent inflationary expectations do not become justified in experience. While a renewal of inflation would relieve some financial strains temporarily, it would quickly recreate the economic and political strains of the 1970s, and it would perpetuate the vicious inflation and collapse cycle.

Fiscal deficits have contributed to high real interest rates in the U.S. and abroad, but especially in the U.S., because they constitute a draft on the private savings that are left after private investment. Private saving in the U.S. (as a percent of gross domestic product) is lower than in any other major industrialized country, and private investment, while not a high fraction of domestic product in relation to other countries, absorbs most of it. The fiscal deficit in the U.S. (federal, state, and local government expenditures less revenues) was about 20 percent of private saving in 1984, and gave rise to an import of capital of capital from the rest of the world of only slightly smaller proportions.

Capital Flows to the United States. Trade data in the second quarter of 1985 confirmed that the United States, largely in the last three years, has consumed or reinvested at home the total value of its once considerable stake of capital abroad and turned from a net creditor to a net debtor nation. The shift on the part of the U.S. from being a capital exporter to being a capital importer was partially due to the relatively high real interest rates in this country. Other factors, however, have been important. Among them is the international debt crisis that appeared with the ending of inflation. U. S. banks and direct investors suddenly sought to terminate further capital flows to excessively indebted countries and to repatriate principal sums when they could. Fears of exchange controls and political instability fed capital flight from countries where drastic austerity was enforced or threatened. U.S. protectionist measures, as well as renewed U.S. economic dynamism, induced some direct investment flow toward the U.S. Ironically, some deregulation of foreign financial markets, urged on foreign governments by the U.S. during the late 1970s when the dollar was weak, freed managers of pension and insurance funds there to shift parts of their portfolios to dollar investments. Steady appreciation of the dollar between 1980 and 1985 added to the attractiveness of dollar investments by both U.S. and foreign investors. In a broad sense, and this was especially true of Japan, excessive national saving relative to government deficits and national investment opportunities mandated investment abroad to provide an outlet for the country's production. Meanwhile, in the U.S., low national saving relative to government deficits and investment opportunities mandated a capital inflow.

The U.S. Trade Imbalance. The dramatic shift in the U.S. international balance of payments on goods and services account, from a surplus rate of approximately $20 billion a year in the second quarter of 1982 to a deficit rate of nearly $120 billion a year in the first three quarters of 1985, is a reflection, of course, of the country's capital inflow. Exchange rates adjust so as to accommodate the totality of demand and supply forces in the exchange market, and a net increase in demand for dollars on capital account raises the dollar's value until there is a corresponding net increase in the supply of dollars on current account. Other forces are, of course, independently at work. The U.S. recovery has led to an increase in the U.S. demand for imports, and disinflationary policies and austerity measures abroad have limited the world's demand for our exports.

Demand restraints in markets abroad have created a fertile breeding ground there for protectionist ideas, including import restraints and export subsidization. Similarly, the overexposure (because of the appreciated dollar) of U.S. export and import-competing industries to foreign competition has led to pleas for import restriction and export subsidy here.

It would be terribly unwise to allow the world-wide recovery from post-inflation recession to be delayed by self-defeating trade wars. Of course it is true that protective commercial policy measures by one government will be countered by other governments. But furthermore, in a world of flexible exchange rates, any improvement a country obtains in balance of payments flows by measures to protect one industry will cause the exchange rate to appreciate, worsening the competitive position of other industries. With capital flows given, the exchange rate adapts to make the whole of the current accounts equal to the capital flow. And, ironically, if protective measures aimed at trade improvement have any effect on capital flows, the effect may be temporarily to enlarge them, enforcing a greater overall trade deficit.

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The International Debt Problem. The external debts of Latin American, Asian, and African countries have become a problem to the industrialized countries because the private capital markets responded too well to the demands political leaders made on them in the 1970s--that they successfully recycle the petro-dollars. The recycling of such funds might have been left to the ingenuity of the sellers of oil, in which case the reluctance of oil exporters to assume risk would have terminated the oil cycle boom much earlier and, with it, some of the rationale for the inflation spiral in the industrialized countries. But political leaders in this country and abroad were afraid of the end of the cycle and urged bankers to provide financial intermediation between oil importers and oil exporters. The involvement of the banks in what, on hindsight, was clearly excessive lending by them and excessive borrowing by certain developing countries has put them in the role of a central player in the international debt crisis.

Great progress has been made toward resolution of the problem. Much of the short-term credit has been rescheduled into longer-term debt, removing the threat that repayment adjustments will be forced on both debtor and creditor countries that are more rapid than either can tolerate. Debtor countries have succeeded in reducing those current account deficits in their external trade which were being financed by borrowing; in some cases, current account surpluses have been achieved, making possible net interest payments not dependent on continued borrowing. It is worth remembering that these balance of payments improvements are partly the mirror image of U.S. balance of payments deterioration.

The problem of servicing the debt, in which the industrialized countries are the intermediary, has been exacerbated by the increase in dollar real

interest rates. Dollar appreciation, on the other hand, has cut two ways: it has eased the task of turning debtor country current account deficits into surpluses, but it has burdened the volume of those countries' exports that is required to service the debt.

A more balanced distribution of recovery across the industrialized countries and lower real interest rates would contribute very significantly to the easing of problems of debt servicing.

In the end, the problem of debt service, where American and other industrialized country banks are holding the bag, is not so much whether the debtors *can* repay as whether they *will*. The rising chorus of demand for radical solutions to the social and economic burden of debt service in developing countries during the summer must have played a part in accelerating in September the G-5 agreement for new efforts on all aspects of the global economic imbalance.

III. The G-5 Initiative and New U.S. Proposals for Dealing with Developing Country Debt

The depreciation of the dollar that had begun at the end of February, 1985, was sharply reversed in August. This must have been an additional catalyst toward bringing to fruition the secret negotiations among finance ministries of the Group of Five large industrialized countries that had been under way since early in the summer. The unusual press conference of the five in New York, September 22, revealed a decision to undertake coordinated interventions in the foreign exchange market, with the goal of reducing the value of the dollar, and intentions to shift the mix of economic policies in several countries.

According to the Wall Street Journal,

> West Germany. . . pledged to step up measures to encourage more private investment, reduce the role of its public sector, streamline its tax code, and broaden its capital markets. There also appeared to be a hint that the Bundesbank may reduce interest rates somewhat.
>
> Japan promised to intensify its efforts to make the yen more widely available for international transactions, manage money and credit policies to push the yen's value higher, allow local governments to borrow more in the markets to help push up interest rates, stimulate demand at home and shift some large government projects into the private sector. The Japanese also are expected to unveil soon a major tax-revision package designed to stimulate consumption.
>
> . . .France promised to adopt policies designed 'to pursue vigorously disinflation.' Paris also agreed to pare its budget deficit and taxes and modernize its financial markets. Britain promised to cut taxes, continue the transfer of publicly run industries to the private sector, and change its labor policies.

For its part, the U.S. pledged "continued Reagan Administration efforts to reduce U.S. budget deficits and resist protectionist pressures in Congress."

The announced policy intentions are clearly the part of the G-5 initiative that is potentially most fundamental, but at the same time they are the part that is least novel and least certain. To achieve a wholesome reduction of global economic imbalances, the U.S. should relax its demand on credit markets by reducing federal fiscal deficits, and it certainly should eschew protectionism. The Europeans should reduce taxes and use the opportunity of growing economies to loosen the market constraints that have made disinflation so costly there in the past. As part of a desirable adjustment the Japanese must encourage greater private and governmental consumption and investment, relative to saving, and they should take additional steps to open their markets to foreign competition.

It remains to be seen whether participants in the financial and other markets will view these announcements as new information--something more credible than past statements of good intentions. If the intentions can be translated into actions, especially in the U.S. and Japan, the yen-dollar

exchange rate, interest rates in the two countries, and the U.S.-Japanese trade imbalance will be affected, all for the better. It is regrettable, in this context, tat U.S. pledges of good behavior are less credible than those of other countries, due to the greater division of powers here between the executive and legislative branches of government.

Meanwhile, the dimension of action that is available to Finance Ministers, without further authorization from their parliaments, is in the exchange markets. On Monday, following the Group announcement, the sale of dollars against foreign currencies began. Since September 22, the interventions are said to have amounted to $7 to $8 billion.

The interventions can clearly have at least a temporary effect on the exchange rates, as they have. The value of the dollar in terms of the yen, at this writing, is off about 10 percent since September 22; in terms of deutschemarks the dollar is off 8 percent, and in terms of sterling it is off 6 percent. Announced intentions of the central banks constitute a piece of information about pressures on the market that other market participants cannot ignore.

On the other hand, one must remember that when exchange market interventions by central banks are "sterilized" (not permitted to influence on-going monetary policies) they tend, with a lag, to generate capital flows which undo the governments' actions. The sterilized sale of dollars by central banks has the net effect of placing additional dollar denominated securities in the hands of U. S. residents and of removing foreign currency securities from the hands of foreigners because the central banks reverse, by securities markets transactions in their own countries, the money supply changes their exchange market operations have brought about. After sterilization, the Federal Reserve Bank

of New York balances its books by having added an amount of foreign currencies to its assets while having reduced its holdings of U.S. government securities. The net changes in the securities required to be held in the private market, however, affect interest rates, raising them slightly in the U.S. and lowering them abroad, and consequently inducing a capital reflow toward the U.S. In "perfect" capital markets this reflow would in time exactly offset the exchange rate effect of a central bank's sustained exchange market intervention, requiring ever larger interventions to maintain any given displacement of the exchange rate.

Consequently, central bank interventions in the exchange markets cannot be expected to be effective for very long unless they grow steadily in magnitude or unless they are perceived as changes in monetary policies. It is chiefly through changes in their monetary, fiscal, and regulatory policies that governments can permanently alter the exchange rates. Fortunately, the forces I have discussed in an earlier section have been unsteadily but surely depreciating the dollar since February of this year. In view of the eight-month trend of the dollar downward, the effectiveness of the recent efforts to accelerate the trend will be difficult to sort out.

At the October meetings of the IMF and World Bank in Seoul, the Secretary of the Treasury unveiled a third dimension of U.S. efforts to facilitate international economic adjustments. He called on developing country debtor nations to sit down with their bankers, and with representatives of the IMF, the World Bank and regional international development banks, to work out their problems. In conjunction with Mr. J. de Larosiere, the IMF Managing Director, he urged on the debtors more market oriented policies and, in return for their cooperation, he offered his influence toward obtaining additional funding from

the commercial banks and the international financial institutions.

The problems here are several fold. Perhaps the chief one is that to again tell Brazil, Mexico, and Peru, for example, how to run their economies is not going to make abandonment by those countries of practices in which important local groups have vested interests any cheaper or easier in political terms. Brazil announced in September its unwillingness to accept IMF conditions for further aid, and Peru has announced its unwillingness to allocate more than 10 percent of its export earnings in any year to debt service.

Furthermore, the Secretary wants to achieve his additional funding "on the cheap." He does not want to add the burden of additional appropriations on the U.S. government's fiscal deficit, and hopes to achieve some of his ends by activating unused borrowing and lending power in the World Bank where his influence is substantial. Otherwise, he promises to lean on the commercial banks.

What must be recognized, however, is that if the World Bank borrows in U.S. credit markets to finance additional loans, it will place some upward pressure on U.S. interest rates, and if it borrows in other markets and exchanges the sums for the dollars debtor countries need for debt service it will add upward pressure on the value of the dollar. Similarly, U.S. commercial bank financing of any additional loans to foreign countries will place upward pressure on U. S. interest rates and the value of the dollar. Whatever the source of dollars found to relieve the plight of the international debtors, the use of the dollars for this purpose will in some degree worsen the dollar scarcity that has kept its exchange value high. In this sense, the Treasury's steps to secure additional funding for the debtor countries is at odds with its efforts to get the exchange value of the dollar down.

IV. Conclusions

The several measures announced by the U.S. and other members of the Group of Five countries in recent weeks involve movement in the right directions. The announcements will be of little long-run significance, however, unless they lead to basic changes in economic policies. At current levels of production, saving must be increased relative to the government deficit and private investment in the U.S., or, abroad, especially in Japan, saving must be reduced or the government deficit or private investment enlarged. More rapid economic growth in other countries will help consolidate the recovery in the U.S. and reduce this country's trading deficit, but growth must be brought about through improved supply-side incentives or other non-inflationary means if the battle against inflation is to continue to be won. A widespread surrender again to efforts to solve problems by monetary expansion would be especially dangerous at this time. Certainly, the most helpful contribution the U.S. Congress can make to global imbalance is to rally its forces in a bipartisan effort significantly to reduce the foreseeable stream of government budget deficit spending.

Limiting the Misalignment of the Dollar

Statement by John Williamson
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before the
Subcommittee on International Finance and Monetary Policy
Committee on Banking, Housing, and Urban Affairs
US Senate
October 23, 1985

The enormous appreciation of the dollar from 1980 to early 1985 has now wreaked devastation to the US external trading position, as long predicted by the Director of my Institute, C. Fred Bergsten (1981). The resulting protectionist pressures, which he also predicted at that time, have now materialized as well, threatening maintenance of the liberal trading system that has provided a cornerstone of postwar world prosperity. I welcome this opportunity of discussing the adequacy of the measures already taken to address these problems at the Group of Five meeting in New York on September 22.

My testimony deals with the causes of the dollar's rise, the consequences of its overvaluation, the corrective actions that have already been taken, and the further actions that are called for.

Causes of the Dollar Appreciation

A major reason for the dollar's appreciation undoubtedly lies in the high real interest rates that have prevailed in the United States in recent years. These high real rates result from the interaction of a very expansionary fiscal policy with what is still a comparatively restrictive monetary policy. Table 1 compares current interest rates in the United States with those in the three other principal financial centers.

An expectation of high real interest rates makes it attractive to invest in dollar-denominated assets rather than in other currencies, even if the dollar is expected to depreciate in real terms in the future. Indeed, the standard explanation of the short-run equilibrium value of a currency is based on this fact. It is argued that a currency with a high real interest

Table 1
Current Interest Rates

	3-month money market rate	Long-term government bonds	Real short-term	Real long-term
Germany	4.8	6.8	2.6	4.6
Japan	6.3	5.7	4.0	3.4
United Kingdom	11.5	10.4	5.3	4.2
United States	7.8	10.7	4.4	7.3

Note. Real rates have been calculated by subtracting the increase in the CPI over the last year from the nominal rates quoted in the first two columns.

Source. The Economist, 12 October 1985, pp. 119-20.

rate will appreciate above its long-run equilibrium value by enough to make asset holders indifferent between holding interest-earning assets denominated in the currency rather than some other. For example, if the DM/dollar rate were expected to return to its long-run real equilibrium within a year, then (given the figures shown in the third column of table 1) the short-run equilibrium value of the dollar could be expected to be 1.8 percent above the long-run equilibrium. If the dollar then depreciated 1.8 percent in real terms over the following year, investors would come out even whether they had held dollars or DM.

A second main factor that has often been invoked to explain the dollar appreciation is the "safe haven" motive--the belief of asset holders that they are more secure against both inflation and expropriation in a country like the United States with a conservative, free-market ideology. There has certainly been an important capital inflow from Latin America explained by such considerations, although more by push than pull. Whether or not it is classified as seeking a safe haven in the United States, there has also been a massive turnaround in the flow of credit extended by US banks, from a net outflow of $45 billion in 1982 to a net inflow of $23 billion in 1984. Unless these flows are expected to be more or less permanent, however, they should not have much impact on the exchange rate, since inflows due to safe haven considerations should be counterbalanced by outflows of funds motivated by interest arbitrage (as described in the previous paragraph).

A third factor often cited to explain the appreciation of the dollar, namely US success in reducing inflation, merits even less credence. In the first place, inflation has fallen almost as much in other industrial countries: according to IMF figures (World Economic Outlook, April 1985, p. 212), the inflation differential between the United States and all industrial countries peaked at an excess of 0.9 percent in 1981 and is expected to be 0.1 percent below the average this year, a relative improvement of only 1 percent. Second, even that overstates the improvement, since US inflation has been slowed and that in other countries has been held up by the exchange rate movements themselves. Third, according to the standard theory outlined above, slower inflation should not cause a real appreciation but just increase the nominal rate of appreciation needed to keep the real rate constant.

Thus I see very little rationale for dollar appreciation beyond what can be explained by high interest rates. The question is: how much can be explained that way? Suppose we take the relevant real interest differential in favor of the dollar as 3.2 percent, the average of the long-term differentials against Germany, Japan, and the United Kingdom. Then a simple calculation based on the standard theory would suggest that the real interest differential could explain a dollar overvaluation of 17 percent if market operators expect a return to long-run

equilibrium within 5 years or 37 percent if they expect such a return to take 10 years.

Unfortunately, however, this calculation is excessively simple. The reason is that the long-run equilibrium rate is itself declining over time as a result of the accumulating US net debtor position in the world, which will require a real depreciation of 1 percent to 2 percent per year in order to generate an improving trade balance to service the debt that is being built up. Thus if the dollar were to depreciate as fast as the interest differential, the excess over long-run equilibrium would fall by at most slightly over 2 percent per year. Since my own estimates (Williamson 1985 p. 79) suggest that the dollar was overvalued by about 37 percent in the fourth quarter of 1984, and it had returned almost to that level before the New York meeting, it seemed evident that a decline in accord with the interest differential would have required a quite implausibly lengthy period in order to reestablish long-run equilibrium. I am reassured to find that this line of reasoning is shared by Paul Krugman (1985) of MIT.

The above analysis implies that the full extent of the dollar's appreciation cannot be explained by rational forward-looking behavior by profit-maximizing asset-holders. What cannot be explained that way is usually described as the consequence of a speculative bubble "hat is, the foreign exchange markets bid the dollar up to mor an it was really worth, because they gave inappropriate crede o gossip about the strength of the American economy and paid inadequate attention to the probability that the dollar would have to decline sharply to limit the US payments deficit and debt buildup. The tendency of President Reagan to treat the dollar's strength as a source of pride rather than a dangerous distortion in relative prices may have intensified the myth of the superdollar and the willingness to pay an unreasonably high price for dollars. And the automatic assumption of many professional economists that markets know better than they do, even on subjects that require fairly sophisticated economic modelling rather than knowledge of demands and supplies that stem from businessmen's day-by-day experience, has deprived the market of the intellectual basis for reaching appropriate outcomes.

Consequences of the Dollar Overvaluation

I agree with most other observers in believing that the overvalued dollar is the primary cause of the US trade deficit, which is expected to reach $150 billion this year. While some part of this deficit can be explained by other factors, notably the greater pressure of demand in the United States as opposed to Europe and the developing countries (where demand is being repressed by the debt crisis), the dollar overvaluation is responsible for at least two-thirds and perhaps three-quarters of the deficit (Marris, forthcoming 1985). The trade deficit has

led to growing US net international indebtedness and strong protectionist pressures. It has caused an estimated loss of 3 million jobs in US manufacturing industries, though this has doubtless been offset in part by the greater growth in defense-related industries and in service employment that was induced by the expansion of demand that would have had to be reined back because of its inflationary consequences without the escape valve of the dollar appreciation and trade deficit.

Corrective Actions Already Taken

After proclaiming since its inception that the dollar's exchange rate was the exclusive business of the market which government neither need nor can influence, the administration made a welcome U-turn in policy at the meeting of the Group of Five in New York on September 22. The motivation was clear: the enormous overvaluation of the dollar had provoked protectionist pressures that could no longer be contained and that threatened to unleash a trade war, with potentially disastrous consequences for the world economy.

Unfortunately the mechanisms that were to produce "some further orderly appreciation of the main non-dollar currencies against the dollar," as the G-5 communiqué described the agreed aim of a dollar depreciation, were less clearly specified than the objective. The declaration that the five governments "stand ready to cooperate more closely to encourage this [depreciation] when to do so would be helpful" was interpreted as a willingness to intervene on a more substantial scale in the exchange markets than had occurred in recent years, with US participation rather than Treasury sniping. But the accompanying list of the policies that each country would pursue recapitulated the same promises--including a reduction in the US fiscal deficit and universal resistance to protectionism--as were repeatedly made through the years during which the dollar overvaluation arose. Hence the key question becomes whether a lead from the authorities backed up only by intervention in the exchange markets can have a lasting effect on the value of the dollar.

Most economists agree that intervention that is not backed up by monetary policy ("sterilized intervention," in the jargon) has weak and uncertain effects on exchange rates. Some go further and argue that it is doomed to futility, but this is unproven. It is true that the Jurgensen Report (1983) concluded that "there was ... broad agreement that sterilized intervention did not generally have a lasting affect" (paragraph 38), but the supporting evidence that was subsequently published (summarized in Henderson and Sampson, 1983) did not make a case as strong as the conclusion might suggest. The experience of 1985--both in February, when concerted well-timed European intervention exploited a minor reverse in the dollar's seemingly inexorable rise to preempt any renewed appreciation, and in September, when mere announcement that the US Treasury thought the dollar was too high plus very limited intervention led to a 5 percent overnight

fall--makes the contention that all sterilized intervention is futile except in the very short run a good deal less convincing than it was before.

In fact, my earlier argument that the dollar's value had in part been bid up by a speculative bubble suggests that a package limited to talk plus intervention may be able to achieve a significant and sustained correction of the dollar exchange rate. The administration's public recognition that the dollar was dangerously overvalued, and the Group of Five's belated acknowledgement that exchange rates have not been reflecting fundamental economic conditions (paragraph 18 of the communiqué), may be sufficient to prick the speculative bubble. The market's knowledge that the authorities are liable to intervene to push the dollar down by "leaning with the wind", rather than that they can be relied upon to smooth the dollar's fall by "leaning against the wind", ought to change market perceptions of the risks of holding the dollar, and may make intervention a more effective tool than it was in the period studied by the Jurgensen Report. And the dollar has indeed declined substantially: my latest estimate is that it was overvalued by 26 percent on October 17. This has brought it down to a range where in my judgement its value may be just about consistent with the fundamentals, including the high real interest rates prevailing in the United States.

Additional Action Needed

Unfortunately it is far from certain that a package limited to talk plus intervention will prove adequate to sustain the worthwhile correction of the dollar that has already occurred: if the market could get things wrong before, it may do so again. Moreover, without action on the fundamentals it is likely that the dollar will remain substantially overvalued. My colleague Stephen Marris calculates that the United States would still have a current account deficit of about $250 billion and a net debt to the rest of the world of over $1 trillion in 1990 if the dollar remained at its level of October 10. Thus American industry will remain dangerously vulnerable to foreign competition and the protectionist threat is unlikely to disappear without further depreciation of the dollar.

There is no doubt what the leading governments would need to do in order to manage the dollar further down. The United States should make a (genuine) big cut in its budget deficit, to allow the Federal Reserve Board to slash interest rates without rekindling inflationary expectations. Those other industrial countries that have low inflation and strong payments positions, like Germany and Japan, should limit the cut in their interest rates but relax their tight fiscal policies enough to ensure that the world does not go into a recession when the United States puts its fiscal house in order.

A far more difficult question is posed by what the Federal

Reserve should do if the stalemate on budgetary action persists. A cut in interest rates might then create a risk of reviving both inflationary expectations and actual inflation. This is certainly unfortunate, but the risk of reviving inflation is not the only risk that decisionmakers confront and it should not be treated as though it were. Indeed, the present is probably a rather favorable time to confront such risks, which will inevitably have to be faced sooner or later unless the budget question is resolved satisfactorily.

In the longer run, it would in my view be highly desirable to secure agreement among the major countries within the context of the IMF on a set of target zones for exchange rates, in order to prevent a recurrence of major exchange rate misalignments with their associated dangers, provide a solid basis for corporate investment plans, and help to induce a more consistent set of macroeconomic policies among the principal economic powers. As I have used the term (Williamson 1985, section 4), "target zones" would involve:

- soft margins, rather than an absolute commitment to prevent the rate from straying outside the target zone
- a zone of perhaps ±10 percent, outside of which rates would be considered "clearly wrong"
- a crawling zone, with the crawl reflecting both differential inflation and any need for balance of payments adjustment
- publication of the target zone
- the partial direction of monetary policy (perhaps in the form of intervention that is not fully sterilized) to discourage the exchange rate from straying outside its target zone.

The essential intellectual jump involved in going from a regime of unorganised floating, such as has prevailed since 1973, to a target zone system is recognition on the part of governments that they have a duty to think about what exchange rate levels are consistent with the rest of their macroeconomic policies and a corresponding obligation to limit the extent to which market rates deviate from those levels, rather than treating exchange rates as residuals in policy determination. Whether they are prepared to recognize it or not, the Group of Five finance ministers made that jump in their New York meeting. A constructive next step would be to instruct the IMF to start estimating figures for what I have termed "fundamental equilibrium exchange rates", or long-run equilibrium rates, and publishing these estimates as a regular service to the international community in International Financial Statistics. The availability of such estimates would permit a more informed debate on whether to advance further toward the establishment of a formal target zone system.

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Statement by

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Mr. Chairman, I am very pleased to have the opportunity to appear before your Subcommittee to discuss the reasons for the high value of the dollar, its consequences, and when the dollar might fall. In the second part of my testimony, I will deal explicitly with the role that the policy of intervention in the exchange market might play in dealing with these problems, in the light of the September 22 statement by the Group of Five finance ministers.

Why is the Dollar High?

Between 1980 and its peak in February of this year, the value of the dollar rose over 80 percent relative to the currencies of ten industrial countries in the Federal Reserve Board's trade-weighted index of the dollar. By mid-September the dollar had gradually declined some 12 percent from the peak, and by October 11 it had fallen another 6 percent since the September 22 statement. What led the dollar to rise so much and then begin to decline?

The primary reason for the strong dollar, in my view, is the decline in the rate of inflation that began in 1980 in response to changes in monetary policy which were put into place in 1979 and confirmed by the election of 1980. During the period 1977-79 in which the dollar fell, the rate of inflation in the United States rose above the average foreign rate of inflation for the first time in post-war history. The reversal of that ominous development in 1981 and the continuation of low inflation since was an event of first-order

importance, which led to renewed confidence in the future value of the dollar.

However, the dollar has risen much more than can be accounted for by differences in inflation rates alone. This is made clear by the fact that the real or inflation-adjusted value of the dollar rose over 70 percent between 1980 and February 1985. Part of the explanation lies in expected future rates of inflation, which have also fallen dramatically from 1980. But the shift in the mix of monetary and fiscal policy that occurred in 1981 is also a major factor.

Up until 1981 for better or worse, monetary and fiscal policy in the United States primarily worked in tandem, expansionary together or contractionary together. Beginning with the 1981 tax reduction and the ensuing buildup in defense spending, weakly counterbalanced by domestic spending cuts, fiscal policy in the United States has become steadily more expansionary, as measured by changes in the cyclically adjusted budget deficit. Monetary policy began on an anti-inflationary course, pushing the economy deep into recession in 1982 after interest rates soared in 1981.

The combination of expansionary fiscal policy and contractionary monetary policy kept real interest rates high in the United States, as the Federal government has required an increasing share of the total supply of funds in credit markets to finance its deficit. With floating exchange rates, the normal response has been capital inflow from abroad and appreciation of the currency. The counterpart of the capital inflow

is a current account deficit made possible in large part by the appreciation of the dollar.

Of course, other factors have also been at work. Tax reductions and a climate of low inflation have induced a sharp rise in foreign direct investment in the United States. Foreign fears of protectionist legislation can also help explain this fact, however, and protectionism has been rising along with the dollar. U.S. investment abroad, and foreign bank lending in particular, have been sharply reduced, due to problems in debt repayment in the developing countries. The debt crisis itself began in 1982, compounded by the high dollar and declining oil and commodity prices. Capital flight from debtor countries has further swelled the capital inflow, leading to more appreciation of the dollar. Finally, in the exchange market as in other asset markets, everybody loves a winner. The expectation of a rising dollar has undoubtedly been a significant factor bringing capital into dollar assets.

Consequences of the High Dollar

The appreciation of the dollar has led to severe losses in the traded goods sector of the U.S. economy. Import-competing industries such as textiles, shoes, furniture, consumer electronics, steel, and power hand-tools have all suffered from increased import penetration, as the soaring dollar has acted like a subsidy to imports. At the same time, traditionally strong export industries, such as agriculture, machinery, scientific equipment, chemicals, and aircraft have lost

export markets as they have been priced out of overseas markets by the high dollar.

Estimates vary, but a study by William L. Helkie of the Federal Reserve Board estimated that 87 percent of the deterioration in the trade deficit between the fourth quarter of 1980 and the fourth quarter of 1984 could be explained by the rise in the value of the dollar.

The decline in our real net exports from $44 billion in 1981 to an annual rate of minus $34 billion in the third quarter of 1985 has cut into the real economic growth of the American economy. Increasingly, higher consumer sales and business investment go into purchases of foreign goods rather than domestically-produced goods. Thus expansionary fiscal policy is being eroded by contractionary appreciation of the dollar, which threatens to push the economy into recession.

Problems for our traded-goods industries translate into problems for all of us, as factories close, farms are sold, and bank failures rise dramatically. It's true that tourists traveling abroad and fixed-income recipients at home do well in a period of deflation and a high dollar. And cheaper imports have reduced the rate of inflation significantly. But these gains come at the expense of producers and workers whose losses are even greater. And when domestic industry screams for protection, Congress hears the call. Unfortunately, tariffs and quotas, a microeconomic reaction, are not the solution to a macroeconomic imbalance such as the high dollar. Indeed, if they reduce

our imports they will exacerbate the problem, since exports must also fall in order to keep capital flowing in to help finance our budget deficit. That way lies a downward spiral to depression.

Another consequence of our current account deficit is that we are now absorbing far more capital inflow (over $100 billion) than all the non-oil developing countries as a group ($30 billion). As our international asset position deteriorates, we will turn from receivers of net interest payments to payers.

When Will the Dollar Fall?

The 12 percent decline in the dollar from February to mid-September can be explained in large part by declining interest rates in the United States, as the economic expansion has slowed sharply this year, reducing the private sector demand for credit. Commercial and industrial loans at weekly reporting large commercial banks, for example, have declined 2.7 percent from March through August. Credit market borrowing by the nonfarm corporate sector fell 30 percent in the first half of 1985 from its 1984 level.

When and if a recession strikes, interest rates and the dollar can both be expected to fall significantly farther. It may be objected that the government deficit will then rise sharply, but private credit demands will fall even more sharply, allowing interest rates to fall and the capital inflow to shrink. At the same time, the current account should improve as imports decline.

An alternative and preferable scenario for a decline in the dollar relates to a shift in the mix of monetary and fiscal policy. It was argued earlier that expansionary fiscal policy combined with tight monetary policy was a major reason for the height of the dollar. Reversing that combination could be expected to require smaller capital inflow and allow a weaker dollar, even without a recession. However, the possibility of gradually reducing the government budget deficit without throwing the economy into recession has probably passed us by a year or two ago.

Monetary policy has already become more expansionary in 1985 as the fiscal stimulus now almost entirely leaks abroad. It is hard to imagine a further step-up in monetary growth phased properly in conjunction with gradual fiscal contraction so as to allow offsetting effects on the economy. That carries fine-tuning to an excess not remembered from the Sixties.

The opposite of fine-tuning has recently been passed by the Senate, in the form of a bill to require arbitrary annual reductions in the deficit to zero by fiscal 1991. This proposal, if I understand it, would punish the economy with spending cuts and tax increases in the (likely) event of a rise in the budget deficit induced by a slow-down in growth that fell short of an actual recession.

A more appropriate policy stance would be to seek gradual reduction in the cyclically-adjusted budget deficit, allowing the automatic stabilizers to play their role as needed. This would undoubtedly

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require attacking some of the budgetary sacred cows which have got us into this mess in the first place. With a stable medium-term path for fiscal policy, monetary policy could then play an appropriate counter-cyclical supporting role.

The Role of Exchange Market Intervention

There are three possible objectives of intervention in the foreign exchange market by the central bank, i.e. buying or selling foreign currencies. The first objective is to prevent or eliminate disorderly market conditions, in which great uncertainty due to some large, unanticipated shock leads to thin markets with wide spreads between bid and ask prices and volatile movements of exchange rates. This relies upon the assumption that the market itself is not going to handle the problem adequately. There must be some kind of market imperfection, either insufficient information or risk aversion. These factors would lead private speculators to respond inadequately, according to the usual argument, so that the exchange market would be found to be inefficient.

There have been a number of tests of exchange market efficiency. The results suggest that either the markets are not fully efficient or that the risk premium demanded by speculators varies systematically over time. This implies that smoothing out disorderly markets is certainly a valid function for intervention.

The second objective for exchange market intervention is smoothing out sustained fluctuations in exchange rates. Such fluctuations might

be caused by over-shooting, when asset markets adjust to shocks more quickly than goods markets adjust. Or they might be caused by "bandwagon" effects or "bubble" effects, as they are sometimes called, in which the herd instinct causes markets to push exchange rates well beyond sustainable levels.

Intervention to smooth out sustained fluctuations makes sense only if private speculation is somehow inadequate to do the job. If that's the case, it must be because the central bank has some kind of information advantage over the private market, especially with respect to the future course of monetary policy, and possibly also fiscal policy. The central bank, of course, is in a position to set future monetary policy, which is a good reason to expect it to have an information advantage over the private market. It appears to me that a smoothing policy has two possible sides to it. It could be used as a substitute for monetary and fiscal policy. That is to say, the central bank could have a plan with respect to future monetary policy and try to use its exchange market intervention to prevent the implications of monetary policy from appearing in the exchange market.

That is what I would call using intervention as a substitute for monetary and fiscal policy. One example of such a policy was the United Kingdom from 1972 to 1975, when monetary and fiscal policy were quite expansionary. Ordinarily, the pound would have depreciated very sharply, but they intervened to prevent that from happening.

There is an alternative possible use for a smoothing policy, as a complement to monetary and fiscal policy. In the United States in the period 1978 to 1980, we were moving toward more restrictive monetary and fiscal policy, and we intervened in the market to strengthen the dollar on the international side, just as we were doing on the domestic side.

The third possible objective for intervention policy is to aim at a target zone, such as that proposed by John Williamson of the Institute for International Economics. This definitely requires monetary policy to act as a complement to exchange rate policy, so the two must act in tandem.

Effectiveness of Intervention

The remaining question is whether intervention can be expected to be effective in achieving its objectives. In order for intervention to be effective, it is necessary for assets denominated in different currencies to be imperfect substitutes in private portfolios. The tests that economists have done are usually not inconsistent with this hypothesis. There appears to be such a thing as exchange risk on foreign-currency assets, and it matters. Similarly, if markets were inefficient, so that individuals were not taking full account of information available to them, it would also be found that intervention can be effective. The tests are also not inconsistent with this hypothesis, although we don't know for sure which hypothesis is correct.

These results imply that sterilized intervention, in which the money supplies of the countries involved are not affected, can have beneficial effects in calming disorderly markets and should be able to reduce the volatility of exchange rates somewhat. By reducing volatility and therefore uncertainty, such intervention should be able to reduce the risk premium demanded by speculators, so as to lead to more stabilizing private speculative behavior and easier financing of current account surpluses and deficits.

With respect to smoothing sustained fluctuations or achieving target zones, success depends on the effective coordination of monetary and fiscal policy with exchange rate policy. It is generally agreed that sterilized intervention alone could not have a large impact over any sustained period of time. But intervention combined with a change in monetary and/or fiscal policy could well play a significant role in smoothing sustained fluctuations, whether caused by over-shooting or bandwagon effects.

The key here is a signalling effect that intervention provides with respect to the future as well as present course of monetary policy. If the central bank is supporting its currency, then this may indicate that its future domestic policy plans are complementary to the exchange market intervention. There is a contrary kind of signal effect, if the market perceives that intervention is being used as a substitute for monetary and fiscal policy action. This can lead the markets to "bet

against the central bank," as a well-known and controversial paper expressed it.

In summarize, I believe that intervention in foreign exchange markets is useful in preventing disorderly markets and, when coordinated with monetary and fiscal policy, can be useful in smoothing sustained fluctuations in exchange rates as well.

The Group of Five Statement on Intervention

On September 22, the finance ministers of the five largest industrial countries met in New York and agreed to cooperate in actions to "encourage" what was called "orderly depreciation of the main non-dollar currencies against the dollar," or in other words depreciation of the dollar. The announced reason was that "exchange rates should play a role in adjusting external imbalances. In order to do this, exchange rates should better reflect fundamental economic conditions than has been the case."

For the United States Government, this is a major change from the policy that had been in place since early 1981. The previous policy was based on the assumption that the market was (almost) always right. When the loose fiscal, tight monetary policy mix pushed the dollar up and strangled domestic industry, the Administration found itself ahoist on its own petard. After four years of vainly fighting off protectionism and refusing to change the monetary-fiscal mix that had led to the

problem, the Reagan Administration suddenly decided that the market may not always be right after all.

As one who believes that intervention can play a useful role in a floating exchange rate policy, I welcome this battlefield conversion. But before they climb into the same foxhole I'm in, I'd like to be sure we're on the same side. According to my line of argument, the dollar has been high primarily because of fundamental factors such as the Administration's fiscal policy, no doubt with some bandwagon effects and other factors added on.

A change in intervention policy without a change in the fundamental factors keeping the dollar up is what I call using intervention as a substitute for monetary and fiscal policy. We may have gone from an intervention policy that is "Do Nothing" to one that tries to "Do Everything!" I don't believe that sterilized intervention alone can produce a lasting, significant fall in the dollar without being accompanied by either a recession or a significant change in fiscal policy. By this late date, it may not be possible without the recession.

If the Reagan Administration continues to pretend that its budgetary cows are sacred when everybody else's are going to be made into hamburger, I don't believe that markets will accept that the fundamental factors really have changed. In that case, the markets will wait until the U.S. economy has run out of gas before letting the dollar drop of its own accord. While the dollar had dropped a noticeable 6

percent by October 1, it didn't move much in the next two weeks on a trade-weighted basis.

To conclude, I welcome the change in intervention policy as a refreshing change from dogmatism to pragmatism. But I fear that it may be used as a temporary palliative to avoid more fundamental policy changes. The evils of protectionism can only be fought with real weapons, not with mirrors.

Senator HEINZ. Should we pass either the Moynihan or Baucus or the Bradley bill; is it legislation that we should turn into law? Mr. Murphy.

Mr. MURPHY. I'm delighted to respond, Mr. Chairman. I think the answer from my point of view is strongly negative.

Senator HEINZ. Would you care to elaborate briefly? This buzzer that just sounded means we're going to have another vote and I don't know what we're going to do about it except I think I have a solution.

Mr. MURPHY. Let me speak briefly on the matter of intervention. There's been a substantial degree of discussion this morning already concerning sterilized versus nonsterilized intervention and I think there has been an admission, which I believe is the truth, that sterilized intervention has little long-run impact on the exchange rates.

COST OF INTERVENTION

I think I will add here only one additional matter, and that is that I suffered some surprise at the discussion earlier this morning that after all a bill like the Moynihan-Baucus bill or Bradley bill involves no cost. That is to say that intervention involves no cost.

There is, I must remind the Senators, no such thing as a free lunch. That is to say, if the intervention which is envisioned is a sterilized intervention, then it means that a central bank like the Federal Reserve System will be purchasing a currency like sterling and borrowing simultaneously on the domestic market—placing Government bonds in the market in order to remove its own contribution to base money supply.

Borrowing on the domestic market affects interest rates and thereby impairs capital formation, and that's one dimension in which the cost might appear.

If, as is commonly believed to be the case, sterilized intervention gives rise to a private capital reflow, the central bank in the United States having borrowed on the market and the Bank of England having loaned to the market and then affected interest rates, so that a private capital reflow is induced, then the cost appears as a form of foreign borrowing. That is to say, we have financed our interventions in the foreign exchange markets by foreign borrowing, foreign borrowing on which we must pay a higher rate of interest than we are likely to earn on central bank holdings of foreign exchange.

Or alternatively, if the matter is not sterilized, then it becomes a contribution to inflation. And I must admit I trust, I hope very much, that the Federal Reserve and Treasury's new initiatives involve sterilized intervention rather than nonsterilized because I believe if they are nonsterilized—that is to say, if they are interventions which involve increases in the base money supply in this country—together with the large fiscal deficits which this Nation continues to run in the Federal budgets, then in fact we will face inflation in fairly short order. In that case, the cost comes in inflation and in terms of the forced savings that come out of the population and in particular the forced savings that come out of the pockets of those least able to bear it.

Senator HEINZ. So your view is that intervention is really dealing with symptoms and that it doesn't really deal with causes?

Mr. MURPHY. I believe that's exactly correct, that unless we do something more fundamental, the initiatives that the Treasury has announced are essentially empty boxes.

Senator HEINZ. Mr. Williamson, what do you think? Are either of these bills meritorious? Should we turn either of them into law?

Mr. WILLIAMSON. I very much like the thoughts that are behind both of the bills. If I were to have to choose between the two, I think I would prefer Senator Bradley's bill. First of all, because it does involve some element of nonsterilization in intervention, although let me return to that in a moment. Second, because it seems to me to have better formulated conditions which limit the circumstances under which the intervention would occur.

Senator HEINZ. So you're saying that on the downside, the Moynihan bill's 3-year automaticity troubles you somewhat?

Mr. WILLIAMSON. If indeed it were to be held to under circumstances in which the dollar had already collapsed within 3 years, it clearly could be very troublesome. Presumably, that wouldn't occur: There would be some sort of override. But insofar as there was an absolute instruction to accumulate $30 billion every 3 years, then in the very circumstances which Senator Moynihan recognized were possible and in which that $30 billion could otherwise be useful, it could instead be an albatross.

Senator HEINZ. Although the mechanism in the Bradley bill is much more sophisticated and a function of discrete steps, nonetheless, aren't there lag time problems with his legislation which if it came in terms of practice as opposed to theory make it pretty much the same?

Mr. WILLIAMSON. I agree that there are indeed similar lag problems and I would therefore welcome further efforts to improve the bill so as to produce an element of discretion at the very least by saying that the intervention didn't have to go through in a quarter if the exchange rate had fallen by more than a certain amount.

Senator HEINZ. I gather, though, that in finding merit with at least the concept behind both bills, you would disagree with Mr. Mulford whose position was that if you want to intervene it is better for people not to know your plans?

A CLEAR STRATEGY WITH TACTICAL FLEXIBILITY

Mr. WILLIAMSON. I think I do disagree with that. I wouldn't disagree with the thought that you need to retain some tactical flexibility from one day to the next to decide the particular timing of the intervention. But if you're going to intervene, then I think you will make it more effective the more clear you are about what the strategy is and what sort of rate you are aiming for.

The idea that intervention is more effective if you're always taking the markets by surprise I find unpersuasive and indeed, on rather general grounds, I object to that type or that degree of——

Senator HEINZ. It's better to let people know more or less what you're going to do and then do it?

Mr. WILLIAMSON. It's desirable to let them know the strategy at which you are aiming, yes.

Senator HEINZ. Mr. Black, what do you think of those two bills?

Mr. BLACK. Well, like Mr. Williamson, I am basically in sympathy with the thought behind the two bills. Unlike him, I think I have more problems perhaps with the Bradley bill approach than with the Moynihan-Baucus bill approach.

Senator HEINZ. Why is that?

Mr. BLACK. That is basically because by specifying unsterilized intervention and providing a schedule of $3 billion per quarter, it amounts to an increase in the monetary base which would be of the order of 5 to 6 percent per year, and this would now be scheduled each quarter and it would, to my mind, remove some of the flexibility from monetary policy which it needs to conduct not only its countercyclical policy but even more importantly would remove its seasonal flexibility.

Senator HEINZ. Would $3 billion a quarter really have that significant an impact on the monetary base?

Mr. BLACK. Well, the base is about $200 billion and so if we talk about $12 billion a year, that's 6 percent, so to speak. And that's of the order of magnitude that it's increasing anyway, if I'm not mistaken, and this would seem to me to remove some of the flexibility from monetary policy.

Senator HEINZ. Well, if you believe that the monetary base relative to all the other creation of credit in the economy, of the velocity, if you believe the monetary base in the relatively short run means a lot, it's hard for many of us to diagram accurately in our little intellectual computers—Peter Ustinov says "the gray matter up here"—exactly how we get from the monetary base to such high orders of M1, M2, M3—the monetary bases seem so small compared to those other measures of what we call money supply. Can you help us understand why a measly $3 billion a quarter in the monetary base is going to affect those other aggregates which everybody focuses on?

Mr. BLACK. Well, let's suppose that it's time for the Fed to remove $3 billion from the monetary base because there is a seasonal drop in demand for credit and a seasonal drop in demand for M1 and the other higher order M's, and yet this bill tells the Fed that they must increase the monetary base by $3 billion when they actually should be reducing it. I think this could cause a significant effect in financial markets and cause interest rates to move to degrees which perhaps are not contemplated by the Senator when he constructed the bill.

Senator HEINZ. I could understand how it could work at cross purposes. It was just the question of scale that I was wondering. Those five lights up there by the way, mean that a vote is in progress and there are less than 7½ minutes for me to transit to the floor.

What I'm going to do is ask Wayne Abernathy, who is the staff director of this hearing, to continue with any questions in my absence and then, since I anticipate another vote, to adjourn the hearing. Wayne, why don't you sit up here at the dais. Actually, while this is unusual, there is precedent for staff to do this and the Chair will declare the hearing adjourned at the conclusion of Mr. Abernathy's questioning.

So, Wayne, thank you very much for standing in and, gentlemen, I apologize that we have had to resort to this unusual stratagem, but I have not yet found a way of being in two places at once.

Mr. Murphy, Mr. Williamson, Mr. Black, thank you very much and I hope for your understanding as well.

Mr. ABERNATHY. If we could proceed to a question with regard to the international monetary system, in the early 1970's the Bretton Woods fixed exchange rate system was basically abandoned, in 1971–73.

In the persistent overvaluation of the dollar, accompanied by record trade deficits that we are currently seeing, are we seeing the breakdown of the post-Bretton Woods free float system? In other words, is a new system needed and, if so, what should it look like? Why don't we start with Mr. Murphy?

ASSESSMENT OF INTERNATIONAL MONETARY SYSTEM

Mr. MURPHY. I'm delighted to respond to that question, Mr. Abernathy, because it seems to me the point needs to be made that any international monetary system, whether it be based on fixed exchange rates or on flexible exchange rates, contains certain rules of policy and certain guidelines which must be pursued by nations in their policy structures if the system is to work well.

Under a system of fixed exchange rates, for example, it is mandatory that countries maintain parallel or somewhat parallel inflation and disinflationary objectives or else they will wreck the pattern of exchange rates. And the failure of countries to do so—indeed, our own failure to participate very well in that system in the late 1960's and early 1970's wrecked that system in 1971–73, as you have said.

A system of flexible exchange rates similarly has rules or guidelines for policies which countries must obey if the system is to work well. Those guidelines primarily have to do with the mix of government policies of various sorts and, most especially, monetary and fiscal policy, which must be so formed that they do not heavily impact the credit markets and induce capital flows which then skew the foreign exchange rates far away from those which are appropriate for private trade and private investment purposes.

The United States flaunted the rules of the earlier system in the late 1960's and the early 1970's and contributed to the demise of that system. We now flaunt very badly the rules of good behavior under a system of flexible exchange rates, and it therefore should be little surprise that the system does not work well.

Indeed, for us to work as a reasonable member of the world community in this kind of system, as well as for domestic objectives, I think it's mandatory that the Congress go back to work, go back to the drawing board, on the matter of the budget and not postpone dealing with the budget question until fiscal years 1987, or 1988, or 1991, but deal with it in fiscal 1986, the year we've just begun. It is primarily through reducing the budget deficit that the U.S. Government can alleviate the major economic problems which have come before this subcommittee and the Senate again and again—the problem of unemployment in our export industries, the prob-

lem of unemployment in our import competing industries, overvaluation of the dollar, and the problems of the international debts.

Mr. ABERNATHY. So you say we need some kind of a system, some sort of rules to follow, if I understand what you're saying, basically rules to stay out—stay out of the system and let it work its will. Is that what you're saying basically?

Mr. MURPHY. I'm not quite sure what you are saying.

Mr. ABERNATHY. Rules for Government to stay out of the exchange markets, out of the international system. You seem to be saying that.

Mr. MURPHY. As I've said before, sterilized intervention in the foreign exchange markets is little more than window dressing. It makes no change in the fundamentals, and it will not change the exchange rates for very long. There will be a lag before a reflow of capital is induced, and one can make temporary changes in the exchange rate, but I do not think one makes permanent changes in the exchange rate by exchange market intervention.

Mr. ABERNATHY. Mr. Williamson, what kind of rules do you think we need in the international system?

Mr. WILLIAMSON. I would very much welcome a move toward a significantly restructured system. I don't think that the attempt to run the world economy with unmanaged exchange rates and a lack of any meaningful coordination of policy among the major countries has worked well, and I would like to go quite some way down the road toward a more structured system.

DISCIPLINING FISCAL MONETARY MIX IN G–5 NATIONS

But let me just say that I think Carter Murphy has made a very useful point in emphasizing that if the present exchange rates system is to work at all, then you might get some significant improvements in the system by this rather modest step of disciplining the fiscal monetary mix in the major countries. I don't think that has been at the root of all the problems of the floating exchange rate system, but it surely has been at the root of the worst of all the problems, which is the overvalued dollar of the past 4 years; and had one had a rule of that sort that was obeyed, then we wouldn't have had a dollar anywhere near as overvalued as it has been. And that would have been a major alleviation. I would like to go beyond that in terms of having governments think about where exchange rates ought to be as an integral part of their overall macroeconomic policy stance, but if one isn't going that far, I do think that Carter Murphy's proposal could take us part way.

Well, as I've indicated, my proposal would go further. It would go back to saying that the level of the exchange rates is an important and integral part of macroeconomic policy: It ought not to be treated as a residual in the process of policy determination. And I do like to think that the Group of 5 Ministers in New York really came much closer to recognizing that point of view than they have done—certainly at any time in the last 4 or 5 years. Maybe you got a bit of this flavor in the later years of the Carter administration but, by and large, since 1973 and the move to floating exchange rates, exchange rates have been regarded very much simply as re-

siduals and not as something about which governments should think.

So that, as I see it, was a large part of the significance of the outcome of the meeting in New York. I share, incidentally, a lot of the concern that not enough has been done to follow up that meeting with action on the fundamentals and I would endorse what was just said about the importance of fiscal action in the United States as a key element of such a followup.

But in terms of what was achieved, it seems to me one did have a recognition that exchange rates matter and then one might say what's the next step from there? The most constructive modest step beyond that, in my view, would be to have the IMF start making estimates attempting to calculate what I have called fundamental equilibrium exchange rates, some notion of target exchange rates, to inform the process of macroeconomic policy coordination and also to inform the process of exchange market intervention in the attempt to get rid of these speculative bubbles which in my view is why the intervention after the meeting of September 22 worked, but it was essentially getting rid of the last gasp of the speculative bubble that had started over a year ago in mid-1984 and driven the dollar to quite preposterous extremes at the end of February of this year.

Beyond that, I would like to see the system move toward what I've called a target-zone approach to exchange rates which I outline very briefly at the end of my written testimony.

Mr. ABERNATHY. Mr. Black.

Mr. BLACK. Well, I would say that the change in policy on September 22 is not the breakdown of the free float system but rather the breakdown of administration ideology that the market is always right. Instead, what we now have is some effort at cooperation amongst countries on exchange rate policy and, as the statement makes clear, also to some extent on monetary and fiscal policy, and that this cooperation I would say is likely to improve the functioning of the floating exchange rate system rather than represent a breakdown in it.

One hope of the switch to floating rates back in 1973 was that it would reduce the so-called discipline of the balance of payments on domestic policies. Countries thought that they were too much constrained by these nasty external problems and prevented from doing what they'd like to do in their great wisdom with their monetary and fiscal policies for domestic purposes. And the result of this change to floating rates in fact was in some sense to allow too much freedom for domestic policies and we have seen then some rather sharp divergences between countries' monetary and fiscal policies that they've come to regret.

For examples on either side, one could easily cite the French move toward a Keynesian expansionism in 1981 and the United States moving in a rather slightly different direction but combining expansionary fiscal and contractionary monetary policy, without taking much account of what this was likely to do on the external front.

I think that the change that the administration has made brings us closer to realizing the continued importance of the external constraint for the domestic mix of monetary and fiscal policy.

I am perhaps a little less optimistic about proceeding all the way to a reform of the international monetary system at a time like this. I think this is, however, to be regarded as a very useful step in the right direction.

Mr. ABERNATHY. If I understand you, all of you together, with different nuances, are calling for a greater coordination of macroeconomic policy, with different goals in mind perhaps.

Mr. MURPHY. Yes.

Mr. WILLIAMSON. That is certainly my view.

Mr. BLACK. And mine.

Mr. ABERNATHY. That's what I gathered. Let me ask you a question that deals with that then.

The Senate recently passed legislation mandating a balanced Federal budget by 1991. If that process goes forward, what effect might we expect it to have on exchange rates? That would be the first question.

And what would be the appropriate corresponding fiscal and monetary policies that should be followed by our major trading partners in order to maintain exchange rate equilibrium? Mr. Williamson, you seem most ready to go on that. Why don't you lead us off on that question?

EFFECTS OF A BALANCED FEDERAL BUDGET

Mr. WILLIAMSON. Well, I think that if the budget deficit is indeed reduced on schedule that that will have an effect on reducing interest rates and that the decline in interest rates will in turn lead to a correction of the present overvaluation of the dollar. It ought to, on average, over the years, although of course Mr. Mulford's point that there are all sorts of other things that come in and have a short-run impact on exchange rates is perfectly correct. The relative pattern of interest rates enables one to calculate a nice expected smooth path of future exchange rates back to their long-run equilibrium, but we all know that in actuality the exchange rates aren't going to exactly follow that path. They're going to jump around all over the place.

But I see no reason to doubt the underlying direction that a reduction in the budget deficit would have. Indeed, if the markets once came to believe that fiscal policy was securely on that course, then I think you would immediately have a fall in long-term interest rates. Long-term real interest rate in the United States at the present time are extremely high. The measure that I present in my written testimony indicates a figure of over 7 percent for the real long-term interest rate in the United States at the present time. That's over double the historical norm. It is 3 percent higher than the other major financial powers on average, and I think that nominal interest rates and therefore real interest rates would start to decline as soon as the financial markets really believed that these measures were intrain. I suppose the fact that we haven't seen a bigger decline in real interest rates in recent weeks suggests that the markets aren't really convinced about that yet.

Mr. ABERNATHY. What kind of macroeconomic coordination would we need to expect from Japan and Germany? What would be their role while we're going through this process of reducing our

budget deficit from $200 billion down to zero? What should they be doing? Mr. Murphy?

Mr. MURPHY. Let me try to respond, Mr. Abernathy. I must say, if I were a member of the Senate and had been asked to vote on the Gramm-Rudman bill, I believe I would have supported it. At the same time, I think that the market must perceive it, both Americans and foreigners must perceive it, as a set of promises the credibility of which are reduced by the fact that it is a set of promises to do something about the budget out in future years when there is no willingness to do anything about the budget now. Therefore, its credibility is somewhat impaired.

Nonetheless, let me suppose, as I think is the thrust of your question, that people did believe that it has established procedures which will, systematically lead to a reduction of the deficit in the U.S. Federal budget between now and 1991. I think, as John Williamson has said, that the market would welcome that and we would see it immediately in long-term interest rates in this country and abroad.

You have asked what policy measures we could reasonably expect and try to persuade other countries to adopt.

We would surely look for somewhat more expansive fiscal policies abroad. Our problem has been a highly expansive fiscal policy in this country with inflation constrained by restraining monetary policy, whereas the contrary is to some degree true abroad.

My former boss at the CEA, Paul McCracken, one time said that the United States has the mix of policies that Japan ought to have and Japan has that mix which we ought to have. So we need while not reversing our courses, to come more toward a medium position.

In particular, we would hope from Japan for a more expansive fiscal policy perhaps accompanied by a somewhat more restraining monetary policy.

From the Europeans, I think we would hope for the same thing, though the central problem perhaps is with Japan, and we would move toward a mix, therefore, in which real interest rates in the world would be somewhat lower and they would certainly be more evenly distributed across nations.

Mr. ABERNATHY. Mr. Black, did you have anything else to add?

POSSIBLE RECESSION

Mr. BLACK. Surely. On the Gramm-Rudman bill itself, aside from doubts about whether in fact anything will eventually be done under it, my problem is that I think the difficulty is to engineer a shift in the mix of policy, with fiscal tightening combined with a monetary easing, which will not in fact push the economy into recession. That's the difficulty we face.

I think we're in a situation now where the expansionary effect of the fiscal deficit has been essentially eroded by the trade deficit and, therefore, we've got no more further thrust coming out of that fiscal deficit on a net basis. So we look to the consumer and we look to business investment for continued support of the expansion, and the consumer is beginning to slow down. We know the saving rate has fallen to a very low rate. It can't fall much more than that. And we know that business investment is beginning to be

scaled back somewhat—the plans are—and more and more of this spending by consumers and business is going abroad at any rate. So I think we're going to find it difficult to avoid falling into recession in any case and the problem with the Gramm-Rudman bill is that it perhaps would, with a slowdown in growth, force tax increases or expenditure cuts which would push you further down.

It would seem to me that it would be far better to enact policy changes now which would have predictable effects out in the future on cyclically adjusted budget deficits and that itself would then generate the favorable effects which John Williamson was mentioning on interest rates, on exchange rates and so forth.

So I would expect a different approach would have a more salutary effect.

Mr. ABERNATHY. So the role for our major trading partners should be basically to take the place of our Government in terms of providing stimulus for the economy?

Mr. BLACK. Right.

Mr. ABERNATHY. The stimulus would be coming to our export sector?

Mr. BLACK. Right.

Mr. ABERNATHY. If I could have your indulgence, Senator Proxmire had two questions that he wanted to have addressed to you.

The first one is to Professors Williamson and Murphy.

The administration contends that high U.S. interest rates are not a key factor behind our strong dollar. Assistant Secretary Mulford, in his prepared testimony, states:

> Undoubtedly, interest rates have been a factor underlying dollar strength over the past 4 years. But unlike the fundamental factors we have noted, the facts do not demonstrate a strong and consistent relationship between the strength of the dollar and interest rate developments over the period of dollar strength as a whole.

Could each of you tell me if you agree or disagree with Mr. Mulford on whether high-interest rates have been a fundamental factor behind the dollar's high value?

Mr. Williamson, do you want to begin on that?

Mr. WILLIAMSON. Yes; I certainly regard high-interest rates as a very major component of the high value of the dollar and a cause of the appreciation. I don't think that they explain everything, but I think the other things which the administration has advanced as possible causes don't make any sense at all in terms of explaining the high value of the dollar.

For example, there is no reason on Earth as to why a prosperous domestic economy in and of itself should cause an appreciation of the currency. Indeed, if anything, the standard view was that that sucked in imports and thereby tended to weaken the currency.

Now that doesn't happen—at least it doesn't happen in all countries, specifically it doesn't happen in the United States. But why doesn't it happen? The reason it doesn't happen is precisely that a domestic boom drives up domestic interest rates and thereby attracts a capital inflow. So that this domestic prosperity factor works only through the medium of the interest rate and it's not an independent factor which can explain the high value of the dollar.

Similarly, I don't think that the decline in inflation in the United States is an important cause of the appreciation of the dollar. If you look at Mr. Mulford's own figures, you find that he

says that inflation in the United States has dropped by 9 percent while that in other countries has dropped by 6.9 percent over the same period. In other words, that's a differential fall of 2.1 percent.

Now most of that differential can be explained simply as the reaction to exchange rate changes themselves. The fact that the dollar was appreciating meant that there was a big relief to inflation in this country and, similarly, the fact that there was depreciation in other countries of their currencies meant that they were importing inflation from the United States. So take that out and there's really no change in differential inflation to begin with.

Even if there is, theory doesn't say that a change in differential inflation should have an impact on the real exchange rate but only on the rate of nominal appreciation or depreciation that's needed in order to keep the real exchange rate constant. What we've seen is an enormous appreciation of the real exchange rate.

ENORMOUS APPRECIATION OF THE REAL EXCHANGE RATE

Hence, in my judgment, these other so-called fundamental factors add up to virtually nothing. The other factors which do seem to me important were market misapprehensions. I think, as I've already said, there was a speculative bubble involved at least from sometime around about the middle of last year up until September 23, and that's one reason that I think that particular intervention, even though sterilized, may have a lasting effect on the exchange rates, because it was essentially pricking the speculative bubble.

Mr. ABERNATHY. Mr. Murphy, do you disagree with Mr. Mulford as well?

Mr. MURPHY. Yes, I do. The steady appreciation of the dollar from the end of 1982 until about last February came at the same time that the current account of the balance of payments in the United States was steadily deteriorating, indicating that the capital flows were dominating the exchange rate.

It is clear that the interest rate pattern is not entirely responsible for the capital flow. The capital flow is a function, as Senator Bradley properly said this morning, of a number of factors, some of them having to do simply with the termination of the inflationary binge of the 1970's and the large debt overhang that was left. It meant that American banks, and particularly the regional banks, were quick to halt their foreign lending. So there was a cessation of American capital outflow and there was an effort to repatriate capital whenever possible.

There was a capital flight from countries where austerity measures were being imposed and where there was a fear of the imposition of exchange controls.

There were other other factors involved. Very fundamentally, in Japan there is this phenomenon of the high rate of savings as compared with the rate of investment that takes place in Japan at world interest rates that makes the Japanese a natural capital exporter. That was accentuated by the market deregulations in Japan which gave pension funds and insurance companies the right to hold foreign assets in their portfolios which led them to shift to dollar assets for these portfolios, here primarily because of the differential in interest rates.

So there have been other factors at work bringing a capital inflow into the United States which have had their impact on the exchange rate.

Nonetheless, it seems to me it would be entirely mistaken and misleading to assert that the large differential between real interest rates in the United States and those abroad had no effect on international capital flows. I am confident they have and, in particular, it's that differential that we could do something about in terms of our own policy mix.

Mr. ABERNATHY. Mr. Black, would you like to comment on that same question?

Mr. BLACK. Yes; I would. There's a specific point that Mr. Mulford made in his testimony that I think is misleading to some extent. That is, he cited the fact that the nominal interest differential between the United States and European countries has declined over this period of the 1980's. While that is true, it's not evidence that it's not interest differentials which are attracting money to the United States.

The reason for that is very simple. The reason is that the profit that's earned by foreigners who sent capital to the United States consists of the interest differential that they earn plus the appreciation that they may expect on the dollar. And what has additionally changed, aside from the change in the nominal interest differential, is the expected rate of change of the dollar.

In the late 1970's, people were expecting the dollar to depreciate and so that required us to have a high-interest differential merely to avoid losing lots of capital. But in the 1980's, people have been expecting an appreciation of the dollar and that has been a more important factor than the interest differential alone, but combined with the interest differential, it has certainly led to significant capital inflow, although that's not the whole story.

Mr. ABERNATHY. Mr. Black, the administration favors a new round of GATT negotiations in order to continue the movement toward free trade which has brought the world and our country so much prosperity since World War II. Mr. Robert Roosa, now a partner in Brown Bros., Harriman & Co., and a highly respected former Under Secretary of the Treasury, recently told the Senate Finance Committee, "that the floating exchange rate system as it now operates will make survival of the GATT concept impossible."

Do you agree with that assessment? If not, why not? If you agree with Mr. Roosa, do you think that we need to reform our international monetary system before proceeding to another round of GATT negotiations?

EFFECTS OF THE FLOATING RATES ON GATT

Mr. BLACK. Well, the statement that the floating rates make the continuation of the GATT system impossible is maybe a little stronger than I would go. I remember very well a conference I was at, I believe it was September 1 year ago, in which both trade relations and financial relations between the United States and the European Community were being discussed. The morning part of the discussion was about trade relations and there was a lot of very difficult discussion about export subsidies, tariffs and so forth, dealing

with agricultural trade, dealing with chemicals and all sorts of complex individual goods and services.

At the end of that discussion, the monetary discussion began, and it was pointed out that the dollar had a very substantial amount of overvaluation to it and the people who were discussing trade threw up their hands and said:

> Why should we continue to bother with these efforts to reduce trade barriers or to prevent new ones from being erected when the monetary factors can throw the trade system out of whack?

I must say I am very sympathetic to the view that the payments imbalances that we have seen, that are caused I think not primarily by the monetary policy but rather by differences in fiscal policy stance, these macroeconomic factors have swamped many of our efforts to keep trade free by means of international negotiations over tariffs and quotas.

Of course, we see the protectionist tide rising all around and I don't need to tell you that in my State of North Carolina there's an awful lot of enthusiasm for the textile bill that's presently before the Congress.

So I would say, with Mr. Roosa, that floating rates make continuation of the GATT system very difficult.

Mr. ABERNATHY. They're putting the pressure on the various countries that are resulting in the trade barriers, as you see it?

Mr. BLACK. That's correct.

Mr. ABERNATHY. Mr. Murphy, please comment on that.

Mr. MURPHY. Yes; I would like to introduce the remark that there is no reform of the international monetary system which will easily resolve our monetary and trade problems. Indeed, with respect to Mr. Roosa's comment that the flexible exchange rate system will bring the demise of GATT, Mr. Roosa would know better than most of us that the GATT, if it has been weakened in its fundamental and early ideal, suffered that weakening under the regime of fixed exchange rates, partially during a period when Mr. Roosa was Under Secretary of the Treasury.

That is to say, the dollar also became a strongly overvalued currency in the late 1960's and early 1970's. It was a period when protectionism was rife in this country. It was a period when foreign governments were imposing capital controls to try to inhibit the flow of capital away from the United States. But it was a period when GATT in fact fell into most of the difficulties with which it's lived since that time.

A world of fixed exchange rates is no happier for trade than a world of flexible exchange rates if governments do not manage their policies with some degree of responsibility toward the international system.

Mr. ABERNATHY. Mr. Williamson.

Mr. WILLIAMSON. If I may just pick up a point made there, certainly either fixed exchange rates or flexible exchange rates are capable of giving rise to large misalignments and I think it's misalignments that are responsible for the pressures on the trading system, pressures which a few weeks ago were reaching what appeared to be a crisis point. Indeed, it was those pressures which stimulated the Ministers of Finance to meet in New York and to

make the decisions they did to at least make some steps toward a more organized monetary system and thereby a monetary system which is easier for the trading system to live with.

I think that we have to be grateful that at least something was done on those lines, but certainly I would like to see further efforts made to move down that road.

Mr. ABERNATHY. Do any of you have anything else that you would like to add before we conclude the hearing?

[No response.]

Mr. ABERNATHY. I appreciate your willingness to remain here in some rather unusual circumstances, but I believe that we've got some very important information in the record that will be very helpful to the Senate and particularly to the Banking Committee as we examine this issue of exchange rates and the international monetary system.

Pursuant to the previous order of the chairman, the hearing is now adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

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